United States Court of Appeals

for the Second Circuit

APPENDIX

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74-1221-1490

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P/S

United States Court of Appeals

FOR THE SECOND CIRCUIT

Docket Nos. 74-1221 and 74-1490

CITIES SERVICE COMPANY,
Plaintiff-Appellee-Appellant,

—against—

UNITED STATES OF AMERICA,
Defendant-Appellant-Appellee.

CONSOLIDATED APPEALS FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

UNITED STATES COURT OF APPEALS
FILED
JUL 17 1974
A. DANIEL FUSARO, CLERK
SECOND CIRCUIT

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Volume II—Pages A-331 to A-665

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shown also.

MR. MURPHY: Your Honor, it is almost 4:30. I am going to have quite a bit longer on cross examination, maybe another hour and a half tomorrow morning so maybe it is a good time to break.

THE COURT: Why don't you go on for about seven minutes.

BY MR. MURPHY:

Q Schedule 9, sir, column 1. What do you mean by after tax income?

A This is generally what is looked upon as what is available as take home pay for the equity. It's after all expenses and after tax, then we add back in the interest to see what was available for interest.

Q Would you say that again, please?

A We look at what is take home pay to the equity.

Q That is after tax income?

A Yes. Then we add back in the interest that was paid but was taken as a deduction for the taxes and this gives me an amount that was available for interest, after payment of my taxes.

Q In your sum that you call available for taxes, you have the net income -- In the sum that was available for payment of interest, you are adding together the

net income of the company after taxes plus the actual interest paid, is that right?

A In effect, yes, sir.

Q And you say that those two make up the amount which the company could pay for interest?

A I have not said that.

Q What do you say?

A I say it was available for it to pay -- maybe I am picking at words.

Q Just look at your chart.

A I have used the term available.

Q Whatdoes that mean, that is what I am trying to find out.

A The amount of net income that would flow to the common and preferred stockholder and I have added interest to that, and I have said that is what is available for interest payment.

Q So what the company could pay for interest then, is the amount they are already paying, right, the amount they are already paying for interest?

MR. CASEY: Your Honor, I think he is badgering the witness. Three times we have gone through this.

THE COURT: I think it is time we went home.

MR. MURPHY: Your Honor --

THE COURT: I don't agree you are badgering the witness. I just think it is time to go home.

We will adjourn to 10:30. I have a matter at 10:00 but I think I will be ready to start at 10:30.

(Time noted 4:30 p.m.)

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Cities Service Co.,

vs.

United States of America

July 18, 1972
10:30 a.m.

(Trial Resumed)

WILLIAM FIELD, the witness, having been previously duly sworn, resumed the stand and testified further as follows:

CROSS-EXAMINATION

BY MR. MURPHY (Continued):

Q Mr. Field, do you have before you Plaintiff's Exhibit 1 for identification?

A Yes, sir.

Q And one in evidence, I should say?

A Yes, sir.

Q Do you recall yesterday when we closed we were talking about schedule 9?

A Yes, sir.

Q We were talking about column 1, right?

A Yes, sir.

Q Would you explain to us, please, what column 1 entails?

A Yes, sir. The column 1, if I could probably give you an example, because I know we had trouble yesterday,

if we could put specific figures down and show you what I have done, it may help you to see, so, yesterday you gave me Appendix B of the order approving the simplification and asked me to look at some figures there, and if you could look in that same order, Appendix D, we have the corporate statement for Cities Service there and I can show you figures I have used in that for a couple of years to show you how I did the computation.

Q Let's do it for 1946.

A Well, '45 is not Appendix B, could I do it for '45? The full year '45 isn't on Appendix D. You have got a 12 months ending October 31, '45. We don't have a '45.

Q Well, '45 isn't on Appendix B, is it?

A Appendix D as in doing, sir.

Q Appendix D as in David?

A Yes, also in David.

Now, if you will note, just to show you some difference in what I have done and what the SEC staff has evidently done, if you will go down and see where they have a ratio times interest and other charges earned after provision for federal income taxes, my ratio --

Q Where is this, sir?

A If you go down to the -- looking at figures it would be the third line from the bottom, the word "three" over in the left-hand column, times interest and other charges earned after provision for federal income taxes.

Q That's page --

THE COURT: What are we talking about now, Appendix B? Appendix B to what?

THE WITNESS: The order approving the simplification --

MR. MURPHY: It is the Cities Service Co. opinion. Yes, it is an exhibit, sir.

THE COURT: All right, as long as we are talking about an exhibit.

Q This Exhibit G to Defendant's Exhibit A in evidence.

THE COURT: All right. As long as we are talking about an exhibit and not something out of the blue.

MR. MURPHY: And this is Appendix D in here, these two pages.

THE COURT: All right, fine, thank you.

MR. MURPHY: This also is officially reported, your Honor, in 25 SEC reports. This is at page 609, 610, the equivalent of what you are looking at now, that schedule.

A Now, what they have shown there is times interest and other charges earned.

Now, if you were to just strike the words"and other charges earned," you would have times interest earned after provision for federal income taxes and that's what I have tried to calculate, so looking at the data here, 1945, they have taken -- they have obtained the ratio of 1.77, but they have taken the total interest and other charges of $8,752,984 and added to what is called net income of $6,741,879, they have obtained a total then of $15,494,863.

Q What is that again?

A That would be what I would call available for interest and other charges.

Q But what it is, in fact, is the total interest and other charges added to what again?

A Net income after taxes.

Q And what number do you give for that?

A $6,741,879.

Now, without worrying what we call it, because I think that's where our problem is, dividing the total of those two items, which is $15,494,863, by the total interest and other charges which is to be covered of $3,752,984, you obtained the ratio 1.77.

Now, I did nearly the same, what I did was I took the interest on debentures and guaranteed bonds of $7,426,529 --

Q Now, wait a second, you did what again?

A I took the interest on debentures and guaranteed bonds.

Q All right.

A Of $7,426,529.

Q All right, interest of 7 million,and then what did you do?

A As my footnote on my table indicates, my interest also includes amortization of debt discount and expense so I added the debt discount and expense amortization of $452,960 and that is the interest of $7,879,489 which appears on schedule 9 of my Appendix A under column 2.

Q That's what column 2 means?

A Yes.

Q And that's the way you compute interest for column 2?

A Yes, sir.

Q Now, what did you do in column 1?

A Okay, I took that $7,879,489, and I added it to the same net income of $6,741,871 that was used in the calculation here to obtain the 1.77, but because I

am covering just interest, I come up with a ratio of 1.86, which is a higher ratio, I might add, than the 1.77 that is used by them.

Q I am just talking about what you did.

A Yes, sir.

Q What you did then, you added interest, right, to the net income of the corporation after tax?

A Yes, sir.

Q To determine how much safety was in the corporation situation?

A I was trying to show a margin left over, so to speak, after interest for the equity, if you mean safety from the equity holders'viewpoint, yes.

Q So the way you determined the safety was you decided -- you took net income, you found out how many times interest was covered by -- it is interest plus net income and that was your margin of safety?

A Yes, sir, which is quite commonly done.

Q And what you did then in this chart was you decided you wanted to find out how much time interest, how much interest was covered by the interest payment itself, and then how much interest was covered by net income of the corporation?

A Yes, sir.

Q Now, is interest paid out of net income, sir?

A Well, net --

Q Can you give a yes or no answer to that question? Is interest paid out of net income?

A It can be paid out of net income but it could be paid out of other things and that was my problem yesterday, because there are other things available to pay interest other than just one year's net income.

Q And by net income in this answer you mean net income after taxes?

A Yes, sir.

Q And would it be your business advice to a corporation to pay interest in 1947 out of net income after taxes? Could you just give a yes or no answer to that, please?

A I would just advise them to pay their interest, sir, to avoid bankruptcy.

Q Would you advise them to pay interest --

MR. MURPHY: Your Honor, could I ask the reporter to read back my original question please?

THE COURT: Sure.

MR. MURPHY: Would you read back the question please?

(The question was read.)

A I'm in the dilemma, if I say yes or no, I can't tell them to just pay out of net income because if they didn't have any net income I still would advise them to pay their interest somehow, some way, even if they have to go to a bank and beg the amount of money to pay that interest.

My advice would be to pay your interest, so I can't say my advice would be just to pay it out of net income. We don't pay interest just out of net income.

Q All right.

Now, I am going to ask you to assume for a hypothetical that this corporation has, as Cities Service did at this time, sufficient income, gross income after deduction of its payments which it had to make to employees, for interest and for other payments that it had to make in the course of its business -- it had sufficient income left out of that before payment of its taxes, which is a proportion of that resulting income, to pay this interest debt, which we will call X, which they are asking your advice about, and after payment of taxes on that gross income net of those charges which we have just described, they also have sufficient income to pay the interest charges on your X debt.

Now, would your advice as an expert to this corporation -- would it be your advice as an expert to this corporation to pay interest charges on their debt X out of the before-tax income or the after-tax income?

A We don't pay our -- we pay our -- we pay interest with a check or with cash that comes out of an account not called net income. We pay our bills as they come in by writing a check, which is to reduce cash.

Now, I don't advise a company to pay its inter-

est out of some stream of income. I advise the company to pay all of its obligations, its wages you mentioned, its taxes, its interest -- I advise them to pay those obligations that could avoid bankruptcy by paying them. They don't pay them out of before or after anything else.

What I am trying to do here is to show what is the safety margin to equity left over out of a given year's income after it's paid all these things, and I am using that to compare them. As my Schedule 10 shows, I compared that same relationship or ratio with other companies. That's all I have done.

Q And this safety -- shall we call it your safety ratio -- that you have computed as you have described for Schedule 9, did you also use that same reasoning in computing your Schedule 10?

A Yes, sir. The date on Schedule 9 is the same for the years '41-'46 as it is in Column 2 of Schedule 10 and merely literally transferred that over to --

Q And for Schedules 13 and 14, did you use the same reasoning in determining that for those tables?

A These are the same logic of trying to see -- but here I've got a different ratio, obviously. I have taken net. I am still looking at all these ratios from the viewpoint of equity. I am trying to ask myself from

the equity viewpoint, what is the performance of this company, and I have taken several ratios. Now, all of them are from the viewpoint of the equity. But certainly Schedule 13 doesn't have an interest added in, or it is not a coverage ratio. I couldn't call 13 a coverage ratio. 9, Schedule 9 and 10 are coverage ratios, which I say are quite commonly used as an example in Schedule D, but we use them -- find them all the time in financial analysis.

Q Yes, sir. Now, passing on to 15 and 16 in your report, you still have it before you, don't you, Mr. Field?

A Yes, sir.

Q Excuse me. I want to refer to page 20. I am sorry to take you around like this.

Page 20 of your report. You see at the top of that page --

A Yes, sir.

Q -- it says:

"For a company with such high operational and business risks, the high debt represents an inordinately high financial risk."

A Yes, sir.

Q Now, what company are you talking about there?

ps4 Field-cross

A The Cities Service Company.

Q Is this the holding company?

A Either one. Cities Service, the parent company or the consolidated. As I tried to indicate earlier, the income that comes to Cities Service, the parent, in the form of dividends and interest doesn't come out of the blue. It has to come from some inherent earnings from operations. If those inherent earnings from those operations are not adequate to pay dividends or to justify the payment of dividends or to enable the payment of interest, then the interest and the dividends won't be coming up to the company.

So the inherent risk of the operating companies in the petroluem business and in the electric and gas business flows up, so to speak, to the parent. It's got the problem. It can only be as strong as the companies it receives the income from. So it is the risk both to the consolidated subsidiaries and to the parent that I am discussing there.

Q So that is what you mean by "company" in that sense?

A Yes, sir.

Q It is the consolidated company, not just the parent company?

A Both. Right. Not --

Q You know what I mean. There is the consolidated company and the parent?

A Yes, sir.

Q What is that difference, by the way?

A Well, in the accounting of it is what I believe you are talking about. The accounting, where you take the statement, balance sheet or income statement, and if we are using consolidated we would take all the companies, subsidiary companies and parent balance sheets, add them together, make minor adjustments for such things as minority interest and try to remove all the inter-related transactions and come up with a consolidated aggregate balance sheet, whereas if we are talking about the company only, the parent company only, we are taking just that single company's balance sheet. The income statement -- the difference would be that in the parent company only we would take into the income to the parent company only those items of dividends normally that are declared and paid and interest received in normal years in good accounting now -- we call this procedure -- whereas in the consolidated we would show the earnings of the companies, the subsidiary companies, and they wouldn't necessarily have been either paid or be available for pay-

ment up to the parent company.

Q So when you are talking about the parent company, then, you are only talking about dividends actually paid into that company as income to the parent, right?

A Yes, sir.

Q And the same thing with debenture interest. You are only talking about interest actually paid to the parent by the subsidiaries?

A Yes, sir.

Q And that would be true in Cities Service companies too; isn't that right?

A When you say "of Cities Service", now, I don't know --

Q I mean the Cities Service Company, the parent.

A You mean in this case here, yes, sir. It is my understanding that Cities Service Company, the parent, would only receive income that was actually paid by the subsidiary, but the income couldn't be paid; the dividend couldn't be paid -- the point I am making -- unless they are earned by the subsidiary and were available for payment.

Q And did Cities Service, the parent, have control over each of its subsidiaries, do you know?

A No one could have the control to bring up to the

parent all income. That kind of control they don't have because the operations of the company would just cease if we don't provide ourselves with a viable company. So if you mean, do they -- and again, the percentages, I think in all cases of those companies that were consolidated, I think the percentage ownership of the common stock would give what is generally conceded to be voting control of the company but not control of all earnings, obviously. That is a myth in finance.

Q But did Cities Service own all the voting stock of its subsidiaries in this time, May of 1947?

A I'm not sure if it was 100 per cent in all cases. I would better -- in all years. I would say it was effective control, if that is what you are asking. As a matter of fact, sometimes State laws require directors ~~outstanding~~ qualifying (sic) shares, and if there are directors owning stock, then the company can't own stock.

Q So during this time the parent, as owning stock of the subsidiaries, had effective voting control over those subsidiaries?

A Yes, sir.

Q And this was true in May 1947?

A Yes, sir.

Q Are you referring to Schedule 18 of your report,

Plaintiff's Exhibit 1?

A Yes, sir.

Q Do you have that before you, sir?

A Yes, sir.

Q How did you compute the number -- first of all, for what company is Schedule 18? The parent or for the full complex?

A Oh, Schedule 18? I'm sorry. I was at page 18 of my report. Schedule 18. I am sorry.

Q All right --

A Will you ask your question again, sir?

Q I say, Schedule 18 refers to the consolidated balance sheet or just the balance sheet of the parent Cities Service?

A Parent company only, sir.

Q Parent alone?

A Yes, sir.

Q And net income in Column 1: What does that consist of?

A You mean of the parent or --

Q Of the parent, yes.

A It's the result of payment after taking all my revenue, taking all my expenses and deduct them out, including tax, I get net income. So it consists of

all those items that were residual to my expenses deducted from revenue, including interest and taxes.

Q So that was made up of the dividend income and the interest income on the debentures less the various expenses of the parent corporation; is that true?

A What was left over after that. I couldn't identify a dollar of net income as being a particular dollar of dividends that came in. We had our expenses, as you understand.

Q I see.

A You understand.

Q Now, Column 2:

What is that made up of?

A That's the -- what was stated to be the dividend provision. My source on the bottom shows that I used the Appendix D of the SEC order dated April 24, 1947, what we were looking at a while ago in our discussion on how we computed interest. I pulled out what is called the dividend requirements for preferred and preference stock shown therein.

I also did my own calculation on a year-end basis, using number of shares outstanding, and I came up to nearly the same figures, but there were slight differences. So I wanted to use these figures hopefully

to avoid argument, and I just put them in there and showed what the amount of the obligation was. There would be, assuming the dividend was paid -- but of course, we know they weren't paid, but I was showing -- of course, if we didn't put what they were, then the arrearages would have gone up, too. So if we didn't pay, the arrearages would have been even greater, so --

Q But Column 2 assumes that Cities Service Company was paying dividends currently on its outstanding preferred and preference stock?

A Yes. This is a "What if" game. What if they paid the preferred dividend? That would have been the amount of all dividend paid.

Q Even though they didn't pay such dividends?

A That's correct. But if we didn't, if we don't pay our current dividends, our arrearages would have been even more. So I wanted to show what would have been available after deducting for dividends if they had been paid, so that we could see what would be available to pay the arrearages. If I hadn't made that deduction, then my arrearages would have been even more. So I couldn't very well have said I could have paid my arrearages by not paying my current dividends.

Q It is your business opinion that it was bad

practice not to pay the dividends as they accrued; is that right?

A Could I have the question again, please?

THE COURT: Read the question.

(Question read.)

A I don't like the word "accrued", because I don't think that is what I talk about here, and I don't think it was my recommendation to say it was bad business and not to pay the dividends as they accumulated. I think it would have been bad business at this point in time to have paid the dividends had they accumulated or as they accumulated.

Q But in your chart you are making the assumption that they did, in fact, pay the dividends?

A Right; to show that the money wasn't available to pay arrearages because if it went to pay dividends it couldn't be used to pay arrearages. If it didn't go to dividends then my arrears would be even more than they were.

Q All right.

And column 3 is the column 2 subtracted from column 1, is that right?

A Yes, sir.

Q Column 4, what is that?

A That's the amount of money that was the cost figure that was actually paid rather than the face figure for stated par value figure of the bonds which were purchased by Cities Service as obligations to meet their purchase fund requirements. I did not include in there, as the footnote indicates, those treasury purchases that could have also been considered a cash drain, which would not have been available then from net income to pay off dividends.

Q So during this whole period this chart shows that Cities Service Company was purchasing debentures, right?

A Yes, quite wisely in my opinion.

Q And this column in column 4 is the total amount of debentures Cities Service purchased in each of these six years, correct?

A No, as I tried to explain I did not include, as my footnote indicates, those that were purchased for treasury purchase. I only included those which were the treasury purchase fund requirement.

Q What debentures were these?

A Most of them 5 per cent gold debentures.

Q Were they Cities Service's own issue debentures?

A Yes, sir.

Q So Cities Service was buying its own debentures during this six year period, is that right?

A As it was required to do, yes, sir.

Q And it purchased each of these amlunts in each of these six years, correct?

A Yes. These are the cost figures, they purchased face value more than these. They bought most of them at discount.

Q Now, you say in column 4 that it is purchase fund requirements, correct?

A Yes, sir.

Q What are those requirements?

A Those are requirements that are set up usually in the indenture agreement of companies that usually require some systematic -- either buying back of the debentures or the buying back or retiring face value, or actually going into the market and buying them, or providing some other sinking fund payment for that.

Q And what did you rely on for your conclusion that these payments were pursuant to debenture purchase fund requirements?

A Well, I relied on -- I don't know if it is sinking fund requirements. I relied on furnishing to me of data which I asked for because this is not external to the analyst, not available to the external analyst as to what the company actually bought back in each of these years in ready form. I asked the company through counsel to provide me with the specific amounts of bonds at face value and at cost that were required subject to purchase fund requirements, and this is what they provided me with in a tabular form.

Q Did you yourself check to see whether the purchase fund required these purchases listed in column 4?

A Those amounts, no, sir, I did not.

Q You just relied on information furnished to you?

A Yes, sir.

Q So except for this -- is that information a part of the record in this case, do you know?

A I think it is by being on column 4.

Q And that's the source of such information, your column 4 in your report, right?

A Yes, sir. Oh, wait. The source of column 4 is some data that was furnished, if that's what you mean. I have got work papers for many of my calculations and I have work papers which they furnished me for that, if that's what you mean. They are Xeroxed.

Q Now,the last item that you considered in determining your opinion in this case is page 21, right. That's sub-part D of your report, page 21.

A Yes, sir.

Q Now, reading page 21, "Such original consideration in the amount of 45 million dollars was not somehow magically reduced just because prices of the preferred and preference shares fell drastically during the depression."

You wrote that, right?

A Yes, sir.

Q " On the otherhand such consideration did not increase just because the prices rose, especially in

1946."

A Yes, sir.

Q Do you know how much the assets Cities Service received for its preferred and preference stocks rose in 1946?

A No, sir, I am not sure I understand.

Q You are saying that such consideration did not increase just because the prices rose especially in 1946?

A Yes, there I am talking about prices of the stock.

Q You are not directing that to the actual original -- so-called original consideration in the alleged amount of 45 million dollars?

A No, here -- in a statement of rose or fell is definitely geared or discussing prices of the preferred and preference stock.

Q Now, Appendix B to your report --

A I am a little consonant deaf.

Q Appendix B as in baby. You wrote that, sir?

A Yes, sir.

Q And that states your educational and professional experience?

A Yes, sir.

Q And I take it you hold a Bachelor's Degree?

A Yes, sir.

Q A Bachelor of Science Degree?

A Yes, sir.

Q Do you have any graduate degrees?

A No, sir. As I indicated I finished my course work, and this course work -- I didn't finish the thesis.

Q You have never worked as a corporate financial officer, have you?

A I am a financial -- I am an officer of our corporation and my specialty is finance. Do you mean have I been a treasurer of a company? Could you be more specific?

Q Yes, a treasurer or a controller.

A I am not and have not been a treasurer or controller.

Q Or worked in a controller's office or treasurer's office?

A I work in work related to our -- very much related to some of the things that our treasurer is concerned with and that's why we have him concerned with it primarily, and I am aware of it.

My main field is financial analysis, the main area I work in as a corporate officer of this, my company, is the field of finance.

Q What is the name of your company again?

A H. Zinder & Associates Inc.

Q How many people work for that company?

A Rough approximation I'd say about 50.

Q 50, 5-0?

A Approximately. That's very rough. I did not count heads recently, but I think that's about it.

Q Does that count secretaries and other support personnel?

A Yes, sir, that would count them as working there, yes, sir.

Q File clerks or people like that?

A Yes, sir.

Q And what's the business of Zinder & Associates?

A We are a firm that very much is oriented toward doing regulatory work before Governmental agencies such as the Federal Power Commission, the Federal Communications Commission, Civil Aeronautics Board. We make presentations, especially in my area of work -- make presentations concerning what is the fair, just and reasonable rate of return requirement for a particular company in a regulatory proceeding, we do Governmental work and also do work for the Canadian Government advising them in both regulatory work and in broad energy matters or matters concerning

energy, the whole field of energy; many of our members of the firm, excluding myself, I am one of the few exceptions that is an actual officer, most of them are actual ex-employees of the Federal Power Commission.

Q How many persons in Zinder & Associates appear before various regulatory bodies?

A Again, approximation, I would say about 15 to 20 of the members of our firm and associates appear.

Q You say 15 or 20?

A Yes, sir, approximately.

Q Who are the officers of Zinder & Associates?

A Mr. H. Zinder, Z-i-n-d-e-r.

Q What's his title?

A He's president, I am sorry, and also chairman of the board.

Q Who else?

A And also I think controlling stockholder, if I recall the figures. There is William Field, F-i-e-l-d.

Q That's yourself, right?

A Yes, sir. Vice-president and side title of economic analyst, I guess you would call me or economist.

There is Mr. Benjamin Schiffer.

There is Mr. Benjamin Miller, Mr. Louis Zanoff, there is Mr. Lloyd Teel, there is Mr. -- Mr. Mc Elfresh,

he's vice-president, I'm afraid I don't his first name. I know his nickname. I can get it easily.

And there is Mr. Harry Trainor, there is Mr. Wallace Cohen, and if I left any of our officers out I hope they forgive me, I can't remember if we have any more. I can certainly get a brochure and go down our corporate records to check. All those men are also stockholders of the firm.

Q So those -- would you accept my calculations that you have named nine persons, including yourself and Mr. Zinder; you say they are all officers of Zinder & Associates?

A If that came up to nine, yes, sir.

Q All right. And there might be more but you can't recall them right at this moment.

A I doubt if I have left many out. If I have left any out, I just didn't anticipate this and I don't have a list of them. Sometimes I forget my wife's name.

Q I notice, turning to page 3 of your Appendix B, the last sentence talks about a study you have prepared:

"Determination of the capitalization rate applicable to the income available to the common stock equity of El Paso Natural Gas Company as of December 31, 1970."

Did you write that, sir?

A Yes, sir.

Q What was it from?

A Primarily we were one of, I think, three firms that were, as a result of a court settlement in Arizona, in an ad valorum tax, our firm was one of the three firms which was chosen to come up with what's called commonly a cap rate which is a shorthand term for capitalization rate.

Q Capitalization what?

A Rate. And that capitalization rate recommendation for the three firms, if I recall the settlement agreement, was going to be averaged, and the result of that average was going to be applied in a capitalization of income model for El Paso Natural Gas which would be used to divide a certain amount of income which was not for me to determine that was to be determined, I believe, through somebody else.

That cap rate would be divided into the proper level of income to come up with what's called a capitalized income approach to valuation and the capitalization of income approach is usually one of three indicators we use in ad valorum tax work. One is the market approach, one is the capitalization of income approach, and one is the cost approach, and our participation, my participation

was to work in the one indicator of value, capitalization of income, and within that indicator my assignment was to come up with just the cap rate or capitalization rate.

Q You were experienced in that form of determination of value?

A Yes, sir, it's very closely related to the question of the fair rate of return, a fair cap rate is very close to a fair rate of return a company should earn and most of my testimony, the preponderance of my testimony has been in the area of a fair, just and reasonable rate of return requirement.

Q Did you, in making your analysis of this company, determine the value that Cities Service could have realized upon the exchange of its debentures for preferred stock by capitalizing the income of Cities Service complex of corporations which would be available for dividends to its common stockholders?

A No, because I was asking myself what was the consideration Cities Service should receive and I did not consider that they received something which they already had a right to which was the income of the company.

Q Is El Paso Gas, by the way, related to Cities Service Company?

A I missed the question, sir.

Q Is El Paso Gas, El Paso Natural Gas Company, related to Cities Service Company?

A They are both in the same industry, in that way they are related.

Do you mean do they have a corporate interrelation?

Q Yes.

A Not that I know of. Somebody may find there is a gentleman on one of the boards that might know somebody or have some stock in the other, but I don't believe there is an intercorporate tie-up.

Q Are you being paid for your testimony in this case?

A I am being paid a salary by my firm and my firm, I am sure, is billing the client for my time that I spent on the study. We usually do.

Q Do you know what your firm's fee is?

A My firm's fee?

Q Yes.

A I don't know if it is completely calculated yet. I can tell you the number of hours I have personally worked on it. I don't bill the client. I am not a billing clerk. The firm has fixed fees for various assignments that usually the clients are aware of because of the work we do with regulated companies, most of the firms are

given, I think, once a year my boss, Mr. Zinder, gives the firms, I think, a recap of each of our fees. I might add that I personally am not party to that list that is sent to the clients and I could not tell you what any one member of my firm is billed at to any one client or group of clients.

Q So your firm's fees in this case hasn't yet been determined?

A I don't think all the billing is in. The fee per hour, I think, has been determined and they have been informed, I am assuming a lot here when I say that, but I am quite sure -- I worked on this job as ~~late~~ early (No) as last October and we don't usually let our bills accumulate. I am sure that we sent Cities a bill for all my work in October and November and December of last year, and probably for -- probably for June of this year a bill may have gone out, yes, sir.

Q But your total fee, the bottom line, shall we say, hasn't yet been determined, is that correct?

A Total bills have not been determined, that's right.

MR. MURPHY: All right, no further questions.

REDIRECT EXAMINATION

BY MR. CASEY:

Q Mr. Field, I only have a couple of questions on redirect. I would like you to read footnote 8 of Judge Mansfield's opinion which for purposes of the record and easy reference I will state is reported at 316 Fed. Sup. 61 at page 70.

A Out loud?

Q No, just to yourself.

A Yes, sir.

Q I will ask you if that comports with your understanding of the effect of a cumulative dividend provision?

A Yes, sir, I read this before and it seemed to be consistent with what was my understanding and what seems to be the typical statement I would find in most textbooks on finance.

Q And you would note that in this footnote there is reference to the qualification that, "Unless the dividends have been withheld in bad faith --" do you see that?

A Yes, sir.

Q And there has been import in some of the questions on cross-examination that dividends were needlessly and deliberately withheld. I ask you whether in your

very extensive study to which you referred in connection with the last question on cross-examination, you found any evidence of bad faith on the part of management in withholding dividends?

A No, sir, I have not in the present case. After my analysis, I would have been very concerned if someone was acting in good faith, if they just were seemingly ignoring the indicators of the problem of the company, if they went out just purposely and deliberately paid all the arrearages and continuation of all current dividends.

Q Now, I would ask you to refer to schedule 9 of your report, Plaintiff's Exhibit 1.

A Schedule 9 or page 9?

Q Schedule 9, please.

I would like to ask you whether the use of the measure of after tax interest coverage, which is the import of schedule 9 is common in financial analysis?

A Yes, sir, it is. Especially where one is trying to determine the adequacies of a level of earnings, and especially if he is trying to determine the adequacies from the viewpoint of the equity holders of the company, and I have a few examples: "The Statistics of Privately Owned Electric Utilities in the United States.," publication

1970, by the Federal Power Commission, devotes at pages 768 and thereon for about 8 or 10 pages, the calculation for literally hundreds of companies, electric companies, it has times times interest earned and it shows which is sometimes commonly done both the before tax and after tax.

The financial and operating -- another publication is the "Financial and Operating Analysis of Privately Owned Electric Utilities in the United States, 1961 through 1970." This is a publication by the Missouri Public Service Commission and this whole publication, each and every page, has a calculation contained on that page, each and every page is a calculation of a times charges earned after tax.

Q How many pages are in that publication?

A 357 pages. The example of after tax interest coverage, but where they threw in coverage of other charges I have already called attention to in the Appendix D of the order approving simplification plan.

Also, we have what is called Fitch Investors Service, Inc., a publication in October 1971, titled, "The Effects of Declining Coverage Ratios in the Utility Industries," and in several tables at the back of that they show an investment viewpoint analysis of the gas pipelines, American

Telegraph and Telephone Company, and the independent telephone industry and one of the calculations they show there is coverage after federal income taxes, on a usage, a very practical usage that we see quite often and just as one example, I refer to the Federal Power Commission reports, volume 44, page 1556, which is opinion No. 589 in the matter of United Gas Pipeline Company, Docket No. RP 7013, at page 1556 of that citation, it makes a statement, a 7.7 -- when I say it, the Federal Power Commission makes the statement, "A 7.78 per cent overall return which we grant herein would yield an after tax coverage of about 2.23 even on the basis of the capitalization and other factors implied by Mr. Davis."

That's a common test that I have seen in many of the reported opinions dealing with a fair rate of return. As far as articles, there is an article appearing in May 11, 1972, Public Utilities Fortnightly, an article by a very well known financial analyst and acquaintance, Mr. Fergus J. McDiarmid, wherein his analysis there of studying coverages is isolated to after interest earned and especially page 22 of that publication shows his usage of those coverages.

This is kind of the top of the iceberg that I pulled together but Moody's Public Utility Manual,

Moody's Industrial Manual, many of the services that we use, and many of the financial analyses that we come across continuously in our business do calculate on an after tax basis. This doesn't mean solely on an after tax basis. It is one of the ways of looking at it, different analyst will make minor adjustments but this is a very commonly done thing.

MR. CASEY: Your Honor, may I have just one moment, please.

THE COURT: Yes.

(Pause.)

MR. CASEY: I have no further questions, your Honor.

THE COURT: You are excused, I think.

(Witness excused.)

THE COURT: We will take a short recess.

(Whereupon, a short recess was taken.)

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MR. CASEY: Your Honor, I would like to call to the stand the witness William Gill.

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W I L L I A M A. G I L L, called as a witness by the plaintiff, being first duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. CASEY:

Q Mr. Gill, I hand you a document, which I will ask the clerk to identify as Plaintiff's Exhibit 4.

(Plaintiff's Exhibit 4 was marked for identification.)

xx Q I ask you if you will describe that document.

A This is a statement of my qualifications and experience and educational background.

Q Did you prepare this document, Mr. Gill?

A Yes; I did.

MR. CASEY: Your Honor, I offer this in evidence as Plaintiff's Exhibit No. 4.

MR. MURPHY: No objection.

(Plaintiff's Exhibit 4 for identification received in evidence.)

xx Q Mr. Gill, were you asked to make a study to determine the effect on the financial condition of

Cities Service Company of the issuance of 3 per cent debentures due 1977 for the outstanding preferred and preference stocks at May 27, 1947?

A Yes, I have, and I've done so.

Q What analyses have you made to prepare yourself to reach an opinion on the financial impact on Cities Service?

A I have made a study of the history of Cities Service. I have reviewed the plan of simplifcation, the SEC findings in the case. I have reviewed the balance sheets of the company, both parent company and consolidated, and I have made some comparisons with oil company ratios, balance sheet ratios.

Q What was the nature of Cities Service's business in May 1947 when the exchange took place?

A Cities Service Company was a holding company with subsidiary companies in the oil, gas -- natural gas business, as well as two principal electric utilities that had not yet been divested.

In the 12 months ended October 31, 1946, approximately 70 per cent of their revenues came from the oil business.

Q What did you do in analyzing the terms of the securities involved in the exchange?

A I reviewed the terms of the securities and, incidentally, Mr. Casey, on page 4 there is a typographical error of my exhibit. The authorized shares of the six-dollar cumulative preferred are 1,500,000. The one million was inadvertently left out.

Q You are referring to page 4, which is Plaintiff's Exhibit 2 in evidence?

A Yes.

THE COURT: It has been corrected.

A (Continuing) I reviewed the terms of the preferred stocks and preference stocks in this case as to their call price, as to their dividend and voting rights as well as to the fact that there was really no restriction on the company issuing debt or stocks equal to the securities or better, having a prior claim to the assets of the company.

I then reviewed the 3 per cent debentures and specifically the covenants contained in the indenture which provided that the Cities could not mortgage or pledge any of its portfolio securities without securing the new debentures to be issued ratably with the additional debt, to the fact that Cities would not create any or assume any funded indebtedness or permit any wholly-owned subsidiary to assume any funded indebtedness unless

it met certain earnings qualifications, and also to the fact that under the debentures Cities could not pay any cash dividends to its common stock except out of earnings subsequent to the year 1946.

It appeared to me that Cities had -- is limited by the debenture, and the restrictions on this were for the benefit of the investors and not for the corporate entity. Therefore, the exchange had converted stockholders' equity into a debt liability.

Q What impact would that have, the conversion of equity into a debt?

A Well, now, they were unconditionally libel for the debt and the interest on the debt, as I think has been brought out previously here, whereas prior to this time they had a conditional liability of preferred dividends. They had bound themselves much more tightly under the terms of these debentures than they had under the preferred stock that was outstanding.

Q Could you tell us what this exchange did to the financial situation of Cities Service Company?

A Yes. In order to understand what it did to the financial condition of Cities Service, I looked at the balance sheet of the parent company and the consolidated company. I looked at the parent company on

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the basis of the actual October 31, 1946 balance sheet published in their plan of simplification, both actual and pro forma, to see what the effect of the plan was.

I examined the balance sheet of the parent company, the audited balance sheet as of December 31, 1946 and 1947, and I examined the consolidated balance sheet as of the year end. These are audited balance sheets, audited by Peat, Marwick & Mitchell, so these are nearest in time to the plan of simplification and after the simplification in terms of audited statements.

Looking first at the parent company actual versus pro forma, which I have indicated as Exhibit No. 1 of my total exhibit, we see the actual at October 31st net current assets of $74 million or 23.6 per cent of the total assets; investments and advances were $236,887,000, or 75.3 per cent of the total net assets, and you had total net assets of $314,394,000.

The investment at that time consisted of 5 per cent debentures in the total amount of $100,488,000 or 31.9 per cent of the total investment.

The preferred and preference stocks, $58,690,000, or 18.7 per cent of the total investment.

Your reserve for undeclared cumulative dividends, $19,661,000 or 6.3 per cent of actual investment, and

your common equity, including contingency reserve, $135,555,000 or 43.1 per cent of the total investment of $314,394,000.

Now, pro forma, which was published to show the effect of this plan of simplification as originally introduced by Cities Service, the net current assets would decline by $42, 172,000 and become but 11.8 per cent of total assets. Your investment and advances would not change: $236,887,000 or 87.2 per cent of the total net assets, which then would decline by some $42,678,000 to $271,716,000.

Your investment, however, you would see the total debentures, the long-term debt, increased by $67,784,000 to $168,272,000 or 61.9 per cent of the total investment.

Your preferred and preference stocks, of course, would be not in the pro forma, as they had been taken care of by the debentures.

Your total common stock equity would be $103,444,000 or $32,000,000 -- $32,111,000 less than the actual balance sheet, and this would comprise 38.1 per cent of your total investment.

Now, we in addition to this -- this would indicate that the company became more highly debt

leveraged by 30 per cent in a total capitalization picture.

We also looked at certain ratios, balance sheet ratios that are of interest when comparing the balance sheet, to see -- or a statement of financial condition to see whether it is improving or not improving. The first is the debt as a per cent of the per cent of stock investment, which was 47 per cent actual and increased to 162.7 per cent.

The net current assets as a per cent of debt, measure of liquidity, mally, were 73.8 per cent in the actual figures and dropped to 19 per cent.

Your total net assets to debt, which is called your asset coverage, was 3.1 times actual, and after the plan it was 1.6 times.

Your current ratio, which is your current liquidity ratio was six times -- this is your current assets to your current liabilities -- six times actual and three and a half times pro forma.

The conclusion you can reach from this first analysis of the actual versus pro forma is that the financial condition was not improved by the plan of simplification. The company became much more highly debt leveraged, and the asset protection declined relative

to the outstanding debt.

My next analysis --

Q Before you leave Exhibit 1 --

A Certainly.

Q -- could you tell us whether the pro forma ratios were in fact a derogation from the company's financial position before the plan?

A Well, I think that's right, yes.

Q Then what did you do in your study of the project?

A I next went to the comparative parent company balance sheet as of the year end December 31, 1946 and the year end December 31, 1947. As I said before, these are the closest in time to the plan of simplification and reflect primarily the effect of that plan of simplification on these statements of financial condition.

As of the end of 1946, your net current assets were $84,932,000 or 26.6 per cent of your total net assets. One year later, this had declined by $43,914,000 to $41,018,000 or 14.4 per cent of your total net assets.

Your investments and advances had increased by about $6,169,000 to $237,073,000 in the year and

represented 83.2 per cent of the total net assets, whereas the year before they had represented 72.4 per cent.

Total net assets had declined by $34,352,000 to $284,799,000. Your investment, which at the end of 1946 consisted of $100,488,000 of debentures, preferred and preference stocks, $58,690,000; reserve for undeclared cumulative dividends, $19,661,000, and common stock equity of $140,332,000.

This capital structure is represented 31.5 per cent by debt, 24.5 per cent by preferred and preference stock and the reserve for the cumulative dividends, and 44 per cent common stock.

One year later, the debentures totaled $172,157,000 or $71,669,000 more than the year earlier, and, more importantly, I think, it represented 60.4 per cent of the total investment.

Meanwhile, the common stock equity had declined from $140,322,000 to $112, 642,000 or 39.6 per cent of the total investment. So there was decline in the common equity of some $27,680,000.

Again, looking at the ratios, your debt as a per cent of stock investment, which was 46 per cent at the end of 1946, was 152.8 per cent at the end of 1947. Your net current assets as a per cent of debt, 84.5 per

cent at the end of 1946; 23.8 per cent at the end of 1947.

Your total net assets to debt, your coverage, 3.2 times, declined to 1.7 times.

The current ratio, 6.8 times, declined to 5.5 times.

So I conclude that the financial condition was not as strong at the end of 1947 as it was at the end of 1946, primarily due to the inclusion of almost $72 million more of debentures in the picture.

Q Was 1947 a profitable year for the company?

A Yes; it was.

Q Could you tell us, Mr. Gill, the import of Exhibit No. 3?

A Yes. Exhibit No. 3 presents the Cities Service Company comparative consolidated balance sheet. This is the company with all its subsidiaries consolidated.

In this case you will see that the total net assets increased from $770, 539,000 to $787,407,000, a slight increase, of about $16,868,000. I say, "slight" in relative numbers to this size of corporation.

Your propeerty account, net of depreciation, increased some $58,028,000, representing 77-1/2 per cent

of total net assets, the 1947 year end, compared to representing 71.6 the year end preceding.

Going back to the net current assets, they declined some $41,472,000 from $175,562,000 at the end of 1946, to $134,090,000 at the end of 1947.

The relative importance in the total net assets:

They were 22.8 per cent in 1946 compared to 17.3 per cent at the end of 1947.

Going down to the capitalization or the investment, the long-term debt at the end of 1946 was $390,113,000, which represented 50.6 per cent of the total capitalization.

One year later, this had increased by $97,131,000 to a figure of $487,244,000 and became 61.9 per cent of your total investment.

The preferred and preference stocks, both of the subsidiary companies and the parent company, declined from $127,542,000 or 16.5 per cent of the capitalization to $44,974,000 or 5.7 per cent of the total capitalization.

The common equity, total common equity at the end of 1946 was $222,390,000, 28.9 per cent of the capitalization, at the end of 1947 was $223,682.000 or 28.4 per cent of the total capitalization.

Again, if we look at the financial ratios, debt as a per cent of stock investment, it was 102.5 per cent at the beginning of 1947. It was 16.23 per cent at the end of 1947.

Your net current assets as a per cent of debt, 45 per cent at the end of 1946, had dropped to 27.5 per cent the end of 1947.

Your total net assets to debt, two times the end of 1946, declined to 1.6 times, while your current ratio, 3.1 times the end of 1946, declined to 2.3 times the end of 1947.

Again, the conclusion is that the financial condition of the company was less favorable at the 1947 year end than it had been at the preceding year end.

THE COURT: We will take a brief recess.

(Recess, during which another matter was heard.)

BY MR. CASEY:

Q I believe we had, Mr. Gill, concluded your statement with respect to your Exhibit No. 3.

A No. 3.

Q Is that right?

A Yes.

Q I will now invite your attention to Exhibit

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No. 4 and ask you to state the reason for the comparison to the ten oil companies which is reflected on that exhibit.

A Yes. I will try to explain.

The Securities & Exchange Commission found that in the 12 months ended October 31, 1946, approximately 70 per cent of Cities' consolidated gross revenues were derived from the operations of its oil business, and, further, we knew that most of its utility properties were to be divested in the near future. Therefore, I believed it was appropriate to make some comparisons of Cities Service's financial condition with those of ten oil companies.

The ten oil companies were listed, and we made comparisons of their long-term debt to the capital stock and surplus of these companies as well as the working capital to the debt, and in Exhibit No. 4 I have set forth the names of the ten oil companies, the amount of long term debt outstanding at the end of 1946 and again at the end of 1 947, as well as capital stock and surplus of these companies and the net working capital, which is the net assets less the -- current assets less the current debt liabilities, and worked out the ratios of debt to stock and working capital to debt.

You will see for the ten companies on average they had a relationship of 23.6 per cent debt to stock, whereas Cities Service had a ratio of 102.5 per cent at the end of 1946.

The oil companies, realizing that the risk in the business was greater than the utility business, finance to a much lesser extent with debt than they do with equities.

Now, when it comes to working capital to debt, we have a relationship at the end of 1946 of 175.1 per cent, the average of these ten companies, compared to Cities Service with only 45 per cent. Again, the ratio of these companies ranges from about 101 per cent of working capital to debt all the way to 524.7 per cent working capital to debt.

Now, at the end, one year later, where we have already seen from our examination of the prior three exhibits that the Cities Service ratios had declined or worsened, if you will, we will take a look at the comparison to the oil companies.

Here, your debt to stock ratio on average for the companies was 22.4 per cent or just about 1 per cent less than it had been the year earlier, which is favorable because it shows a lessening debt to total capital

structure, whereas Cities Service had gone from 102.5 per cent to 162.3 per cent, primarily as a result of the issuance of debentures for preferred stock.

The working capital to debt had an average ratio of 230.4 per cent, whereas Cities Service had declined from 45 per cent to 27.5 per cent.

So I concluded here that Cities Service, which was now in a business that carried a greater risk than previously when they were in the utility and oil business, had ratios that became less favorable at the end of 1947 than they were at the end of 1946, and even at the end of 1946 they were not favorable, compared to other oil companies.

Q Mr. Gill, I note that Tidewater Associated Oil Company, with a working capital-to-debt ratio of 524.7, increased to 882.8 in 1947, and it seems that in both those years this was higher by far.

Did you make any comparisons excluding Tidewater from your analysis?

A Well, we can work out the ratio without it. As a matter of fact, at the end of 1947, if you exclude Tidewater and use nine companies, your ratio is about 158 per cent for the nine companies, slightly less than it was for the -- well, I didn't take it out for the year

before, but it can be done. I don't have the figures. I would have to go back to the work papers. But it would still be far, far greater than it would be for your Cities Service Company.

Q Now, having made the comparisons noted on all of the schedules of your report, Plaintiff's Exhibit No. 2, could you state what your overall opinion is with respect to the impact on Cities Service Company of the exchange of debentures for preferred and preference shares?

A Yes. Based on the study of the financial statements which I have made, I concluded that the issuance of the debentures, 3 per cent debentures, for the preferred and preference stock and the retirement of a portion of the 5 per cent debentures outstanding under the plan of simplification did not improve the financial condition of Cities Service at May 27, 1947. The company became highly debt leveraged at a time when the dependency on revenues from the oil business was greater than in the past and was the principal source of its earnings.

Cities' capital structure was unlike that of the oil companies, which found the risk not suitable for heavy debt financing, but instead of a reduction in debt operations the plan of simplification imposed a greater

debt burden on the company and thus, I believe, a greater amount of risk for the company, and therefore I concluded that it was not favorable; the financial condition had not improved for the company. It was not a favorable --

Q Had it deteriorated?

A From all facts that I see here, it had deteriorated, yes.

MR. CASEY: Your witness.

CROSS EXAMINATION

BY MR. WILSON:

Q Mr. Gill, my name is Samuel Wilson. I am Assistant United States Attorney, and I represent the defendant in this action.

Mr. Gill, you were asked by Cities Service to prepare an opinion on the plan of exchange involved here.

A As the effect on the financial condition, yes.

Q Have you read Judge Mansfield's decision in preparing your opinion?

A Yes; I have.

Q Have you read the SEC's decision, which involved the plan of simplification promulgated in April of 1947?

A Yes, sir.

Q Mr. Gill, could the common stockholders of Cities Service receive any dividends before the preferred and preference stocks were brought up to date in the arrearages?

A Under the terms of the comulative preferred, no. I am sure they couldn't until the preferred got their dividends, the cumulative dividends.

Q Mr. Gill, I refer to page 7 of your report, Plaintiff's Exhibit 2, and I read from the second paragraph from the bottom:

"Prior to the exchange there was only a conditional obligation to pay dividends on the preferred and preference shares."

What do you mean by a conditional obligation?

A This was not an obligation that was mandatory upon the directors of Cities Service but only an obligation to pay dividends when, as and if they saw fit and if the financial condition in their opinion permitted the payment of dividends. It's not like interest, that has to be paid, regardless.

Q And what was the yield on Cities Service common stock so long as there were arrears on the preferred stock?

A If you are talking about dividend, your cash dividend yield, if there was no cash dividend, there was no yield. Common stocks don't often sell completely on a dividend yield basis.

Q For how many years prior to the effective date of this plan had Cities Service common stock gone without dividends?

A I can't answer you exactly, but if they hadn't paid the dividends on the cumulative preferred since 1932, I am sure that the common stock did not get any dividends in those years, cash dividends.

Q What was the level of current assets of Cities Service Company in 1946, October 31, 1946? I think you can find that in your Exhibit 1.

A Yes. $74,122,000.

Q That figure represents net current assets; is that correct?

A That's your current assets less your current liabilities; yes, sir.

Q Do you know how much of that was in cash and Government securities?

A Well, we could look at the -- at the plan of simplification. I think that says cash and Government securities -- the actual October 31, 1946 cash in banks

and on hand was $85,755,000, in round figures.

Q I am sorry. Could you repeat that number?

A The balance sheet, the actual cash in banks and on hand, $85,755,820.

Q As of what date is that?

A October 31, 1946. I thought that was the date you asked me about.

Q I ask you to look at Appendix B of the Securities & Exchange Commission decision in this matter, on page 605 of the SEC reports, and I point out the entry for current assets, cash and other Government securities and ask you to read the number.

A $88,780,821. The difference is, I gave you the cash in banks and on hand, and I didn't add the securities, which are separate in the plan of simplification, but the two of them total that.

Q And what was Cities Service's earned surplus on October 31, 1946?

A $69,262,000.

Q You analyzed the corporate balance sheets of Cities Service in preparing your opinion; is that correct?

A Yes, sir.

Q What does the term "reserve" mean to you as it

appears on the corporate balance sheet?

A It depends on what the reserve indicates, what further title is given to the reserve.

Q Well, first I would like to know generally what a reserve in accounting parlance means.

A A reserve is a setting aside of some amount on the balance sheet, indicating that it is going to be used for such a purpose and no other purpose. It is an indication that quite often they set aside from surplus reserve so that the -- this amount will not be considered by the investors or the public as available for any other purpose.

Q Does one set aside reserves for predictable contingencies?

A It can -- it can be done, yes.

Q Referring to Exhibit 1 of your report, am I correct that that represents a comparison of Cities Service Company's actual balance sheet and pro forma balance sheet as of October 31, 1946?

A Yes, as presented by Cities Service in their plan of simplification of November 20th.

Q And do you know what assumptions were made in preparing the pro forma section of that balance sheet?

A Generally, yes.

Q Could you outline those to us?

A In the plan of simplification, they intended to pay off some $40 million, in round figures, of the 5 per cent debentures out of the cash. They intended to issue debentures of $108,362,000 in exchange for the preferred and preference shares. That was the principal changes in the pro forma balance sheet.

Q And you have taken this balance sheet from what source, as appears in Exhibit 1?

A From the plan, Cities Service's plan of simplification of corporate structure.

Q As filed with the SEC?

A Yes.

Q Is it fair to state that your conclusion, at least in part, has been that Cities Service had incurred a much higher level of debt as a result of this change?

A It definitely had incurred a higher level of debt.

BY MR. WILSON:

Q Aside from the question of debt, what other factors, as affecting Cities Service Corporation, did you take into account in preparing your opinion?

A I was asked to study the effect on the financial condition, and I studied all the factors that I thought were necessary, including the history of Cities Service, what it had become, how it measured up to other companies on the financial condition, I have already gone through my analysis of the balance sheet as far as the asset and the investment side or capitalization side is concerned.

I considered all these factors from the viewpoint of what a well informed investor or financial analyst at the time would see or conclude.

Q Other than what appears on the balance sheet of the corporation, did you take into account any other considerations?

A Well, I considered the -- I think I have testified I considered the terms of the securities being issued as compared to the securities that were outstanding, and such factors as I considered important.

Q What value in your analysis did you give to the voting rights of the preferred stockholders

which were acquired by Cities Service in the exchange?

A I considered the voting rights and found that the preferred stock had a voting power in total of about one-third that of the voting power of the common stock. The common stock was entitled to, as I recall, one-half a vote per share, whereas your preferred and preference BB, your $6 preference, was entitled to one vote per share and your preference B 60 cent was entitled to one-tenth of a vote per share.

The preferred stock could not outvote the common stock.

Q That is not my question.

My question is, did you consider that --

A Yes.

Q -- in your analysis, and what weight did you give to the question of the vote that was given up by the preferred stockholders and acquired by Cities Service Company.

A I gave it such weight as it deserved.

Q And what weight did you think it deserved?

A I think I just explained that to you.

Q Did you put a dollar figure on the value?

A No.

Q Do you know how widely dispersed the preferred

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stock was in terms of ownership?

A I don't know.

Q Do you know how widely dispersed the common stock was in terms of number of owners?

A I can give you the number maybe, I recall looking at it but I can't give it to you offhand. I'd have to try looking it up.

Q You testified that Exhibit 1 to your report, was taken from the Cities Service plan as filed on November 20, 1946.

I am reading from the bottom of that exhibit. Is that correct?

A Yes, sir.

Q Was that plan amended before it was approved by the SEC?

A Yes, it was.

Q And was that amended by Cities Service Company?

A Yes.

Q What amendments were made in that plan?

A First of all amendments were to increase the face amount of the debentures issued to the call price of these preferred and preference stocks, to not require a vote of the stockholders to approve the plan -- I am trying to think of anything else in there, but principally --

THE COURT: I think they were reduced to a term of 30 years?

THE WITNESS: Yes, the term of the debentures was reduced from 50 years to 30 years.

Q Was there any commitment made by Cities Service as to effect on other bond issues at that time?

A I don't think I understand your question.

Q I will rephrase the question.

Did Cities Service make any commitment in its amended plan as concerned any other outstanding bonds or any outstanding bonds at that time?

A I think under the plan they agreed to redeem from the sale, subsequent sale of their utility properties, the 5 per cent debentures and such other amount as they may receive to reduce the outstanding amount of the new 3 per cent debentures.

Q Was this devotion of proceeds of the utilities companies sales to be in addition to the purchases they were going to make under the original plan? The purchases of 5 per cent bonds outstanding is what I am referring to.

A Yes. I am not sure whether this was originally stated under the original plan and revised in the subsequent plan or it was in both plans. I am not quite clear on that.

Q As a result of the revised plan did Cities Service make commitment to purchase 40 million dollars, approximately 40 million dollars, in 5 per cent gold bonds then outstanding of Cities Service Company and -- well, answer that portion if you will, please.

A They made that provision in the original plan and I think it was reflected in the pro forma here, and I think it may have in the subsequent been revised also.

Q Did they, as part of the revised plan, make a commitment to expend the proceeds of the sale of certain named utilities to apply those proceeds to the retirement of additional 5 per cent bonds outstanding in 1946?

A Yes, I think I already said that.

Q And they then provided that if there was any excess from the sale of the utility companies over the proceeds necessary to entirely retire the fives, they would apply that to retire a portion of the new 3 per cent bonds, is that correct?

A That's correct, contingent on receipt of sufficient funds to do so and at some future time.

MR. WILSON: Your Honor, the amended plans to which I have been referring is Exhibit F to Government's Exhibit A that is in the motion papers.

Q Do you know what utility companies Cities had commit

itself to sell as part of this plan?

A I believe it was the Ohio Public Service Company and the Toledo Edison Company.

Q Do you know what value was placed upon those companies by the SEC, if any?

A Well, I think the SEC had some figures in there, but I don't know if that's the SEC's value or whether they accepted some other experts or the company's indication of what the value might be.

Q Reading from page 577 of the SEC reports as to the Cities Service Company matter:

"Annexed hereto as Appendices B and C are balance sheets of Cities Service Corporation, corporate and consolidated respectively as at October 31, 1946 per books pro forma giving effect to the plan and pro forma adjusted to reflect the sale in partial compliance with the outstanding divestment orders of the Toledo Edison Company, the Ohio Public Service Company, Spokane Gas and Fuel Company, Federal Light and Traction Company, and the Dolphin Light and Power Company hereinafter sometimes referred to as the properties designated for immediate sale and the application of proceeds therefrom estimated by the company at 85 million dollars to the retirement of the remaining outstanding 5 per cent debentures

aggregating $59,910,200 principal amount and the retirement of 25 million principal amount of 3 per cent debentures due 1977."

Did you consider that transaction as part of the amended plan in your calculations?

A That transaction had not occurred as of the time that I reviewed the financial statements.

The audited financial statements even six months later did not reflect that; this was a contingency to occur in the future and I am not sure how many years in the future before it did occur and before this was, in fact, applied.

Q Again, I ask, did you consider that in your calculations?

A Yes.

Q What effect, what weight did you give to that factor in your calculations?

A I think I tried to explain that to you, Mr. Wilson, before, that this was a plan, a contingency, provided they sold these properties in the future and at that time they would apply such excess as was not needed to redeem the 5 per cent debentures; to, to redeem with the 3 per cent debentures. However, that had not occurred by the end of the following year.

If you are studying the financial condition of a company at that time, the auditors were not allowed to put it on the balance sheet and this is what the investors look at.

THE COURT: All right, we will go and have some lunch.

(Whereupon, a luncheon recess was taken.)

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AFTERNOON SESSION

(2.10 p.m.)

W I L L I A M A. G I L L, resumed.

CROSS EXAMINATION (Continued)

BY MR. WILSON:

Q Mr. Gill, just to review for a moment, you testified this morning that you had examined the effect on the balance sheet of Cities Service Company of this plan of simplification; is that correct?

A Yes. The financial condition of Cities Service as represented by their balance sheets.

Q And you expressed the opinion that the increase in debt which is reflected upon those balance sheets was a negative aspect to this plan so far as Cities Service was concerned; is that correct?

A I think that you can characterize it as that, yes.

Q Did the plan as approved by the SEC require that Cities Service apply the proceeds of the sale of certain named utilities to the retirement of debentures, both 5 per cent and 3 per cent debentures?

THE COURT: Doesn't the plan speak for itself?

MR. WILSON: It does, your Honor. I'd like to call it to the witness' attention.

THE COURT: Why don't you do it that way.

Q Do you recall that the plan called for the application of certain utility company proceeds, upon the sale of those utilities, to the debentures of Cities Service Company?

A I think I already stated that earlier in my testimony.

Q Do you recall what these utilities were carried, at what value these utility companies were carried on Cities Service's books?

A No, I don't recall.

Q I show you Appendix F at page 616 of the SEC report of this case, in the SEC reports. I ask you what value were the electric companies carried upon Cities Service's books?

A The electric utility subsidiaries were -- preferred stocks were carried at $157, 545,000; the common stocks were carried at $35 million -- excuse me, this is -- I thought it was in thousands of dollars. It's in dollars. So that number should be $157,545. Common stocks were carried at $35,583,541.

Q Just so there is no confusion, that is $157,000 and some-odd dollars for the preferred stock of the utility companies listed on Appendix F and $35,583,000

for the common stocks of those same companies; is that correct?

A Yes. That is the investment at carrying values as of January 13, 1947.

Q Thank you.

Do you recall what Cities Service Company expected to realize upon the sale of those same utility companies?

A I think you read a figure this morning from the appendix of the SEC mentioning $85 million as a company figure.

Q I show you page 577 of the SEC report and ask if the material thereon refreshes your recollection as to the company's projected receipt upon sale?

A Yes, it does.

Q What is that number?

A $85 million.

Q Thank you.

Mr. Gill, you analyzed the actual and pro forma balance sheets of Cities Service Company, on pages 8 and 9 of your report; is that correct?

A Yes. It runs over into 10, too, I gather, and 11.

Q On page 9 you deal with ratios that you have

calculated from your Exhibit 1; is that correct?

A Yes.

Q In the third paragraph there on page 9, I note that you calculate, I believe it is four different ratios.

Debt to other capital -- correct me if I am wrong, please, Mr. Gill -- net current assets to debt; net assets to debt; and current liabilities -- I'm sorry -- the current ratio.

Those four ratios are mentioned on that page.

A They are.

Q What is the current ratio?

A The current ratio is the relationship of the current assets to the current liabilities and, generally stated in terms of how many times current assets are to current liabilities.

Q Is debt a function of that ratio, or involved in that calculation of that ratio?

A Is debt a function?

Q Strike that. I will reframe the question.

Is debt a factor in calculation of that ratio?

A It is to the extent that the current debt is in the current liabilities, current portion of the debt may be in the current portion of liabilities.

Q On page 11 of your report, based on Exhibit 3 you make certain additional calculations of the financial condition of the consolidated company; is that correct?

A Yes.

Q And you calculate long-term debt as a percentage of the capital investment, I believe at the foot of the page?

A Percentage of the other stock investment, yes.

Oh, I see what you are talking about. Yes. As a per cent of the total capital.

Q I am reading,

"Long-term debt amounted to $390,113,000 or 50.6 per cent of total capital investment on December 31, 1946."

Did you make that statement?

A Yes. I see that.

Q And you point out that debt had increased one year later; is that correct?

A Yes.

Q And on page 12 you examined the debt ratio again, debt to other investment?

A Yes.

Q And you point out that the coverage of debt had been changed by this plan; is that correct?

A You are talking about asset coverage?

Q Yes. Net current assets as a percentage of debt?

A Yes.

Q And asset coverage had been changed by the plan?

A Yes.

Q And it is your conclusion that these changes were as a result of the plan of simplification?

A Principally as a result of the plan of simplification.

Q Had that plan of simplification called for the sale of certain utility companies?

A It was mentioned -- I don't know whether it was mentioned in the plan of simplification or the SEC order; but it was to sell utilities. I think we have mentioned that before.

Q Does the application of those proceeds or does that sale in any way enter into the calculations that you have made in any of your exhibits here?

A That sale had not been made at the end of --

Q That is not my question.

I am saying, did the sale enter into any of your calculations that appear in connection with your report or in your report?

A I don't know how else I can answer that. If the sale hadn't taken place the figures aren't in my report, as far as financial figures and the auditors, Peat, Marwick & Mitchell had not audited -- had audited these figures and had not put the sale in there, because it was not a fact.

Q Did you state on page 2 of your report that in your opinion as to the effect on the financial condition of Cities was reached after consideration after all the factors we believe would have been considered by a sophisticated informed investor or financial analyst at the time?

THE COURT: At the time.

A I think you are reading from my document, yes.

Q That is page 2 of your report I am reading from.

A Yes.

Q Did the sale of those utilities enter into your calculations here in any way that is apparent in your report?

A It entered into my conclusions the way any informed investor at the time would have thought about it, they said -- when they sell these properties some time in

the future, we will apply it first to the 5 per cent debentures. If there is anything left over, we will apply it to the 3 per cent debentures.

There was no way an investor could get any money out of this until it was done.

Q In reference to Exhibit 1 of your report you have broken that down into actual and pro forma of the parent company for October 31, 1946; is that correct?

A Yes, sir.

Q What does the pro forma figure or column represent?

A Mr. Wilson, it represents what Cities Service Company published as a plan of simplification and showed as pro forma in that plan of simplification.

Q Did Cities Service prepare any other estimates that were available to you that would show the effect of the amended plan?

A I presume they prepared them and there are some in the SEC finding.

Q Did the SEC findings also contain an adjusted pro forma set of figures to reflect the effect of the sale of these public utility companies?

A Yes, they did.

Q Have you used those figures in your calculations

in this report?

A No, sir, I have not.

Q In Exhibit 2 of your report, referring to the line where investments appears, entitled debentures, in 1946 you show $100,488,000; and in 1947 you show $172,157,000; is that correct?

A Yes.

Q What caused that change?

A There are several things that caused the change.

One is the -- the principal cause is the plan of simplification issuing $115 million worth of 3 per cent debentures. At the same time they retired some $40 million of the 5 per cent debentures. And that is the principal.

There might have been some sinking fund changes, but they are rather minor in nature, I would think.

Q Under, I think it is the total under common stock equity, you show in 1946, $140,322,000?

A Yes, sir.

Q And in 1947 the corresponding figure is $112,642,000?

A Yes.

Q What caused the reduction?

A Well, there was a recuction in earned surplus

primarily and a reduction of a contingency reserve, that caused the principal reduction there.

And this is an adjustment for again, I believe, the issuance of the debentures.

Q What contingency reserve was that?

A I don't know what -- that is what it was entitled, contingency reserve. That is the only title I have on it.

MR. WILSON: All right.

I withdraw that question.

BY MR. WILSON:

Q We have seen that the utility companies were valued by management according to the SEC's report at 85 million dollars, is that correct?

A That's what that states in that SEC finding.

Q And the book value as shown in that same SEC finding which I have just shown you was approximately 35 --

A 35 or 36 million I think you said.

Q Approximately $35,500,000. So that according to management's estimates, were the book values of those companies below the market values?

A They are below what the company estimated they could get on a sale, I guess.

Q Did you examine Cities Service's record or make any analysis to determine whether other properties of Cities Service were similarly under-valued, on the books of the company, that is?

A I don't know how you could make that analysis at this time, Mr. Wilson.

Q Did you do it?

A No.

THE COURT: Is "under-valued" the right term? The fact that something might be above cost would not

necessarily be the cost of an under-valuation.

MR. WILSON: I would say they were carried on the books and valued below what management believed the market value to be, is that correct?

A They were carried on the books in accordance with probably good accounting practice which says you put them on the books at cost.

Q But that value was below what management, as that opinion is presented in the SEC report, believed market value to be for those same properties?

A Carrying a value of 35 million is certainly below an estimate of future sale estimated at 85 million.

Q What would have been the effect upon your calculations of each of the ratios wherein you include debt, and there have been several of them that we have mentioned, upon consummation of this plan as projected by management of Cities Service Company in 1946 -- I am sorry, 1947?

A I don't know if you can make that calculation without knowing when the date of sale would be.

Q Did management make that calculation --

A I don't know if management --

Q -- and present it to the SEC?

A I don't know who made the calculation, whether

the SEC did it on their own or whether management presented it. I can't answer it.

Q Does the calculation to that effect appear in the SEC report?

A There is an adjusted pro forma, assuming that certain monies would be received in the future, yes.

Q I show you the SEC report in this Cities Service reorganization, page 605, and call your attention -- that's Appendix B -- to the column entitled "Pro Forma Adjusted," with a footnote B I believe that is -- I do agree it is a little difficult to read the B but I would ask you to read here and satisfy yourself as to whether or not that column represents an adjusted to reflect the sale of the utility companies and the application of the proceeds of that sale?

A Yes, I can read it if you would like.

Q Is that what that column represents?

A That's what that column represents, I would say.

Q Referring to your Exhibit 1, the total debentures under "Actual" and "Pro Forma" are indicated at one hundred million, four hundred odd thousand actual and one hundred sixty eight million approximately three hundred thousand pro forma forgiving effect to the plan, is that correct?

A Yes, the original plan before amended, that is.

Q Did you indicate in your report the effect of the amended plan or affect of the amended plan on that figure, or either of those figures?

A Well, the effect -- I think I state in my report that it is increased by 7 million dollars in the text, in the amended plan.

Q And that was to allow for what change between the amended and the original?

A Well, it was to allow for the call price rather than the stated value of the preference stocks.

Q I show you Appendix B of the SEC report at page 606 and refer you to the line entitled, "Total Long Term Debt."

Would that be equivalent to your total debentures on your Exhibit 1 in terms of the meaning of that line as opposed to the numbers?

A I don't understand your question because they are all debentures and it is total long term debt. It is the same amount.

Q Was there any other long term debt involved in this corporation that we are aware of here that appears on these statements?

A Not in the parent company.

Q So then am I correct that total long term

debt on the Appendix B of the SEC decision appearing on page 606 corresponds to total debentures under "Actual," in your Exhibit 1?

A That's right.

Q And the numbers correspond?

A They do.

Q Right. And if we allow for the adjustment for the additional call premium, adding approximately six million eight hundred thousand or six million and some odd, to your pro forma figure on total debentures, your Exhibit 1, we would come up with the same figure the SEC has, for total long term debt of 175 million, is that correct?

A That's correct.

Q Under the plan of simplification, what type of an obligation did Cities Service exchange for its preferred stock, is it debt, equity?

A Debt.

Q And under the plan of simplification for Cities Service to retire certain 5 per cent debentures --

MR. CASEY: Your Honor --

THE COURT: I think we are throwing around some words here, retiring and obligations and things of that nature. I didn't know that this was a retirement.

These are misleading words in the record.

MR. WILSON: I will rephrase the question.

Q Under the plan of simplification, did Cities Service Company agree to pay off certain 5 per cent debentures in cash?

A Yes.

Q Did they also agree that the remainder of those 5 per cent debentures not paid off by cash would be paid off by a subsequent transaction or as a result of a subsequent transaction?

A They did, with no time on when the transactions would take place.

Q Assuming for the moment that that transaction had occurred as projected by management at the time and by the SEC, what would have been the effect on Cities Service Company's overall debt position?

A Well, if they had sold it, and lived up to this, they would have reduced the debt by whatever amount they got on the sale.

Q I quote from your page 14 of your report and ask whether you wrote this statement:

"Instead of a reduction in the debt obligations, the plan of simplification imposed a greater debt burden on the company and therefore a greater element of

risk to it."

Did you write that, Mr. Gill?

A Yes.

Q Referring once again, that is, for the first time, to Exhibit 4 of your report, what is the purpose of this exhibit?

A As I stated my report, on direct testimony, the purpose was to comepare Cities Service's financial ratios with those of ten oil companies, principally because Cities Service, as we have seen, had 70 per cent of its revenues in the year ended October 31, 1946, from oil business.

Q Did you analyze what per cent of their capital was invested in the oil business?

A No, sir.

Q Have you made a comparison between or among Cities Service and a number of oil companies to compare certain ratios in order to draw conclusions to Cities' position, is that correct?

A Yes, I did, with the --

Q What ratios did you use?

A Well, as I stated on Exhibit No. 4 your debt to your stock, and the working capital of the debt.

Q I believe you testified on direct, and your exhibit demonstrates, that oil companies had a lower

percentage of debt in their makeup or in their ratios than did Cities Service, is that correct?

A Yes.

Q Why is it that oil companies don't carry or have more debt in their structure?

A Why they don't have more debt?

Q That's right.

A Because the risk of the business is such that it is not as stable as a utility business that is allowed to earn a fair rate of return. There is much greater risk in the oil business and you cannot borrow that type of money in the oil business. It is equity money.

Q Will you assume for the moment a profitable operation as we have, a net income figure, a positive net income figure. Would it be more advantageous or would it be advantageous to an oil company to have more debt in its structure?

A More debt thatn what?

Q Than it has -- more debt than is reflected in the figures you give here for the various oil companies.

A Mr. Wilson, I'd hate to put myself in the shoes of these men who are managing ten large oil companies who decided that this is the kind of capital structure

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that they have to operate. I think what you are talking about is trying to get more leverage into this type of a business, more debt leverage, and I would refer you to companies like Boise-Cascade and Litton Industries and some of the other companies that went this route and in spite of economic conditions today find themselves in a very, very poor position.

MR. WILSON: I have no further questions of this witness.

REDIRECT EXAMINATION

BY MR. CASEY:

Q Mr. Gill, if you compare debt to assets and you reduce debt by selling assets, you have reduced both sides of the ratio, haven't you?

A That's right.

Q So that also I would ask you, the company without the plan could have retired the debt by using 40 million dollars in cash and by selling properties and applying the proceeds of sale, there were no inhibitions in the Cities Service capital structure that prevented that, is that true?

A To the best of my knowledge, yes, it is.

MR. CASEY: I have no further questions.

MR. WILSON: No further questions.

MR. CASEY: The plaintiff rests, your Honor.

(Witness excused.)

MR. MURPHY: Your Honor, at this time the Government moves to dismiss the plaintiff's complaint for lack of proof on the issue of fact involved in this case, that there was a loss on this exchange of debentures for preferred stock.

I can argue this motion at this time if the Court please.

THE COURT: Well, if you want to argue it, now is just as good a time as any.

MR. MURPHY: The issue before the Court is whether the company taxpayer, Cities Service Company, has suffered a loss on this exchange of preferred stock and accumulated dividends for issuance of debentures.

Now, for this Court's determination on the issue of fact left open by Judge Mansfield is the amount of such loss. We have had three witnesses put forth by Cities Service Company before they rested. Two of them in the abstract argued there was a loss, but gave no dollar figure for such loss. The third, the middle witness, argued that there was a loss and purported to set that loss at the difference between 115 million and 45 million or 70 million dollars.

It is the Government's position that since two of the witnesses have presented no concrete amount of such loss covered, that we have to look only to the third witness in order to determine that there was a loss that we can qualify with a dollar amount, and that witness' testimony the Government contends is incredible to this Court.

The Government contends that that witness is not qualified as an expert witness as is shown by his own testimony on cross-examination and specifically the Government refers to his testimony on schedule 9 which was attached to his complaint.

In that schedule 9, the witness used the ratio --

THE COURT: To his exhibit not to the complaint.

MR. MURPHY: That's right, to his exhibit. That's right, your Honor.

Schedule 9 attached to his exhibit. In that schedule 9, the witness, Mr. Field, used the ratio of interest to net income after taxes plus interest, and the Government in cross-examination asked him several questions about that. Mr. Field testified that such ratio in his opinion was intended to show the safety of the corporation or how many times the interest payment was

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covered by that corporation. And he sought to justify use of that number by referring to other companies and other reports which he claims used that number.

Well, the Government contends, irrespective of whether other companies used that number, Mr. Field did not understand what that number meant, and that was clear on his cross-examination, because the Government asked him, as a businessman, if he would recommend to his clients that they pay interest with after tax monies or with before tax monies, and Mr. Field answered somewhat as my wife perhaps might answer, that we pay taxes with checks. That's not testimony of an expert witness.

Any expert witness, the Government contends, with any understanding of what he is doing in the field will tell the Court that when he is paying an obligation of a company which is a deductible obligation -- and the Government contends that interest has been deductible in the United States for the last 50 years -- he will pay that money with his gross income, i.e., his income before taxes, rather than purporting to pay it with net income, and any witness who acts as an expert witness who is unable to make that distinction on cross-examination is unworthy of belief.

Under those circumstances, your Honor,

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and there is further material, but the Government contends that that one point explicitly states the substance of the Government's contention on that issue, that that witness is unworthy of belief.

Therefore, you are set with a situation here where there is no figure as to the loss of the company, taxpayer, whosoever in this trial, except that set forth by a witness the Government claims is incredible.

Further, I have some further remarks, shall we say, on this 45 million dollar alleged figure. Judge Mansfield stated in his opinion that the 45 million -- that the Government reserved its right to contest that 45 million figure. There has been no evidence presented concerning that 45 million dollar figure.

Plaintiff is a taxpayer seeking to recover a tax refund and as a plaintiff in the action he has the burden as to that 45 million and he has presented that evidence, so that in itself is false.

THE COURT: I thought that was conceded that that was for the purpose of -- at least Judge Mansfield's order says the value of those shares to plaintiff shall be no less than $45,323,846, the value of the consideration originally received for their issuance.

MR. MURPHY: The Government contends the

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value of the consideration received is the stated value. Unless they can prove anything to the contrary. The stated value is in their records. It has been so stated throughout this SEC and now we come up with another now lower value and we don't have any independent proof for something beyond the stated value.

THE COURT: The only issue before me is the value to the plaintiff of the preferred and preference shares received by it in exchange for the issuance of the 3 per cent sinking fund debentures on May 27, 1947.

There have been various suggestions made but to what extent they appear in the present record I am not quite sure. One is that the matter of accumulated dividends on the preferred and preference shares and the call price should be disregarded in determining what, if any, value was received by the plaintiff, and I assume we have had the evidence that has been produced to negate any attribution of value to those particular items.

Reading Judge Mansfield's opinion he made some mention also, not being in dispute, that the market value of the preferred and preference stock on the basis of discounting the pending simplification and all that was somewhere around 80 some odd million dollars and there was no dispute as to that figure.

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MR. MURPHY: That's right, your Honor. But he said that figure is not determinative --

THE COURT: I have heard no argument that that figure should be taken as the value of the preferred and and preference stock to the corporation, to the plaintiff.

I might mention that as a figure being in the record.

I can't necessarily go along with the attack on the competency of the expert. Sometimes there is difficulty in framing questions, which makes it difficult for the witness to answer; lack of understanding as to what is implied in the question, and so forth.

But if there is nothing further you want to say, I will hear from the plaintiff.

MR. CASEY: Your Honor, what's incredible is the position just taken by my brother, that unless you pay taxes you can't pay interest, you can't pay compensation, you can't pay anything. The distinction between paying interest and before tax or after tax dollars is perfectly ridiculous --

THE COURT: Well, I am more interested in deciding the issues that are presented to me here, rather than going into philosophy. I am trying to

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get the facts.

Maybe you can enlighten me on what you have shown.

MR. CASEY: We have been under mandate to resolve the question at this trial as to the value to the plaintiff, if any, of the preferred and preference shares received by it in exchange for the issuance of its 3 per cent-30 year sinking fund debentures on May 27, 1947; and we are under further mandate that the value of these shares shall be no less than the $45 million which was the value of the property originally received when the preferred and preference shares were issued, if there is a peculiar value to the corporation in removing from its capital structure a preferred stock with dividend arrearage, and that peculiar value exceeds $45 million, it becomes the measure of discount.

We have presented to the court three qualified expert witnesses, all of whom have spent a lot of time on the project, and each one of whom have said that the preferred and preference shares received by the plaintiff had no intrinsic value to the plaintiff in the circumstances of the exchange. And I believe that that carries our burden. And now the burden of going forward shifts to the defendant.

THE COURT: Defendant's motion is denied.

MR. WILSON: The Government calls JOhn O'Farrell to the stand.

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J O H N O ' F A R R E L L , called as a witness by the Government, being first duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. WILSON:

Q Mr. O'Farrell, where are you employed?

A The Internal Revenue Service in the National Office in Washington, D.C.

Q Are you in any particular branch or section of the Internal Revenue Service?

A I am in the valuation analysis section of the Income Division.

Q For how long have you been employed by the Internal Revenue Service?

A Since 1960; almost 12 years.

Q How long have you been in the valuation analysis section?

A All of that time.

Q What are your duties in the valuation analysis section of the Internal Revenue Service?

A I am a valuation engineer and I work full-time on appraisal of properties.

Q What type of properties do you appraise or value?

A Securities, leases, real estate, patents, various types of property.

Q Do you have any other responsibilities in the valuation analysis section where you are employed?

A I am classified as a senior engineer, and so I am a reviewer in the section, along with one of the other men. We divide up the reviewing responsibilities.

Q What does a reviewer do, Mr. O'Farrell?

A Well, he is generally responsible for the assignment of the cases as they come in; most of them being cases in litigation. And is available for discussion or consultation, and reviews the report when made before it is sent out, and signs for it before it is sent out of the office, as well as -- countersigns, you might say, because the appraiser himself signs the report.

Q Prior to going to work for the Internal Revenue Service where were you employed?

A I was employed on railroads generally for a period of about 25 years.

A I went to the public schools in West Virginia, and I received a Bachelor of Science in civil engineering from West Virginia University, and a Master of Arts in economics from George Washington University.

Q Have you testified previously as valuation analyst or expert?

A Yes, sir.

Q What has been the subject matter of your testimony in those matters?

A Various valuation items. About probably half of them have been securities.

Q Have you testified in court before?

A Not before my service with the Internal Revenue.

Q What I mean, Mr. O'Farrell, is have you testified in court prior to this occasion?

A Oh, yes. Yes, sir.

Q Approximately how many times have you testified in various courts prior to today?

A 15 or more. 16.

Q I'm sorry, I can't hear you, Mr. O'Farrell.

A I think 16 times, but I'm not certain.

Q Approximately how many times have you testified as to the evaluation of securities?

A I don't know exactly, but it's eight to ten times.

Q Have you prepared valuation analyses in securities cases that were not tried?

A A number of times.

Q How has that occurred?

A Sir?

Q How does that occur?

A There is a tendency, if it is possible, for the attorneys to settle cases with valuations, if possible. And out of the cases that we work up valuations on, I would say they don't try over 5 per cent of them.

Q In approximately how many cases have you prepared valuations of securities in overall, whether they were tried or not?

A Roughly 200.

Q Are you a member of any professional groups relevant to the valuation analysis and that sort of thing?

A The Washington Society of Securities Analysts and the Federal Appraisers Association, are the only two.

Q In the course of your employment with the Internal Revenue Service were you asked to prepare a valuation analysis of the exchange of Cities Service

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preferred and preference stock for debentures, which occurred in 1947?

A Yes, I was.

Q Have you reached a conclusion as to the value to Cities Service in that transaction?

MR. CASEY: Your Honor, before the witness answers that question I would like to ask him one or two questions on voir dire, derived from the examination so far.

We have had not had the advantage of an exhibit showing his qualifications. It is apparent that -- may I have your permission to ask a couple of questions?

THE COURT: Yes.

VOIR DIRE EXAMINATION

BY MR. CASEY:

Q Mr. Farrell, your employment is with the Commissioner of Internal Revenue, is that not correct?

A By the Internal Revenue Service.

Q Internal Revenue Service.

And in your day-to-day duties you are, as an eployee of the Internal Revenue Service, called upon to advise the other employees of the Revenue Service on valuation positions which will directly affect the selection

of tax, is that not correct?

A No, sir. I don't advise them on positions to take. I advise them if they request it, on valuation matters pertaining to valuation. But we are not assigned any positions in our valuation.

Q But the purpose of your employment is to support the Internal Revenue Service in the --

THE COURT: The Court will take judicial notice of the fact that he is employed by the Government.

MR. CASEY: Your Honor, I don't think that this witness brings the disinterested approach to the problem that is demanded of an expert witness in this case, and I move to --

THE COURT: That goes more to the weight to be given. I will permit him to testify. But I have noted your objection.

BY MR. WILSON:

Q Mr. O'Farrell, were you asked to prepare a valuation report on this transaction?

A Yes, sir.

Q Were you told what your position had to be before you prepared the report?

A We are never told what position. We are given the information that is available inside the Service and

told to make an appraisal.

Q I refer to Defendant's Exhibit C and ask whether this is the original of your report that you prepared in this matter?

Is this the report you prepared in response to to the request (handing)?

A Yes, that is the report.

Q Do you have a copy of that report to refer to?

A I have.

THE COURT: Did you receive a copy of this report, Mr. Casey?

MR. CASEY: Yes, we have it, your Honor.

Q What does this report contain, Mr. O'Farrell?

A It contains an estimate of value with supporting and complementing and reference information. It was used in the study and in the development of the conclusion.

Q What materials did you draw upon in preparing your valuation?

A I reviewed what I considered were pertinent parts of the record in the hearings of the Cities Service before the Securities & Exchange Commission in 1946, the latter part of 1946 and the early part of '47. I reviewed some contemporary literature at that time, periodicals,

such as the Commercial & Financial Chronicle, Dun's Review, and Moody's publications, annuals. And I reviewed Judge Mansfield's decision on the order of the SEC, and 25 SEC 575, and information that had accumulated in the Government's files on the subject.

Q What is the question you sought to answer, in your evaluation analysis?

A I will read it from the report:

The issue that I was to give attention to was that statement in Judge Mansfield's report in which he said,

"We conclude that the sole material fact actually controverted is the value to plaintiff of the preferred and preference shares received by it upon the issuance of the debentures and that no genuine issue is presented as to all other material facts which shall be deemed established."

Q Does your report represent your analysis of that question?

A Yes, sir.

Q How did you approach the question or problem?

A As Judge Mansfield stated in his statement of what was required to complete that case, the item of major interest, in fact, the only interest as far as I

was concerned, was the value to plaintiff of the preferred and preference shares as of this particular date, which was May 27, 1947, when the transaction took place in which the preferred and prefdrence shares of the Cities Service Company were exchanged for the debentures of the same company.

In examining the issue, it was obvious that the value to Cities Service was the value to its owners, and the owners of Cities Service, it being an ordinary statutory corporation, were the common stockholders. And what advantage, what value, what worth was it to them to remove the preferred and preference shares and the dividend arrears from those shares.

So that is what I directed my attention to, was to find for the Cities Service, as the proxy and representative and the financial group focus of their stockholders, what value was it to them to remove these impediments or barriers that they presented to their full participation in the financial results of the company.

At that time the company had a record of several years of progressive improvement; it had greatly increased its surplus; it had greatly increased its earning power. The SEC, in its order had reviewed the decision during these several years preceding 1947 and they had come to the con-

clusion, or accepted the figures that were presented by Cities Service, that for the year 1947 it could be anticipated that the company would earn before taxes two different figures, they stated.

One was $29-1/2 million on a pro forma basis in which it was contemplated that the last $60 million of the 5 per cent debentures that were outstanding would not be redeemed, and a pro forma adjusted figure of $24,500,000 based on the assumption that these $60 million in debentures would be redeemed.

So taking these two figures, of $29-1/2 million and $24-1/2 million, I arrived at an estimate of mean being of $27 million that would be available before taxes to Cities Service as net income in the year 1947. I thought this had been a very conservative figure to project into the future and to capitalize to obtain the worth to the company of the barrier they were removing through retirement or redemption or exchange for the preferred stock and the arrearage.

The Cities Service figure that I am using is a consolidated figure, so I applied a 50 per cent tax to that. The 38 per cent was the effective tax at that time, but following World War II the taxes had been in a state of flux, and so just to be more conservative, I

used the 50 per cent for a long period projection into the future.

That brought the figure down to 13-1/2 million dollars. Then the Cities Service itself as a parent was a holding company, and it could have paid out 90, 95 per cent of its earnings after taxes without any disturbance to the company. But as I was using the consolidated figures I allowed for a 50 per cent payout and reduced it $13-1/2 million to $6,750,000, which I considered on a very conservative basis could be projected as dividends available to the common stockholders of Cities Service for the foreseeable future as a result of the removal of the preferred and preference stock and the arrearage.

At that time the Standard & Poor's index showed that the average yield on common stock was just about 5 per cent. And I considered Cities Service an average company. And using that yield it means that for every dollar of yield it could be capitalized on the basis of a multiple of 20. So taking the $6,750,000 projected dividends and multiplying it by 20, I obtained a figure of $135 million.

This to me and by conventional appraisal technique represented the capitalized value of the

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anticipated yield to the common stockholders of Cities Service. And that I accepted as a measure of the value of the removal of the preferred and preference stock and their arrears to the company, Cities Service Company.

THE COURT: We will take a short recess.

(Recess.)

BY MR. WILSON:

Q Mr. O'Farrell, in applying this yield analysis what value did you place upon the preferred and preference stock received by Cities Service in this exchange?

A Including the arrears, $135,million.

Q Were your calculations based on the consolidated income of Cities Service Company?

A On consolidated as forecast by the SEC based on information that Cities Service had given them.

Q Referring to page 9 of your report --

THE COURT: Is that in evidence?

MR. WILSON: Yes, it is, your Honor.

Exhibit C.

THE COURT: Do you have any extra copies of it?

MR. WILSON: You can take this copy.

(Handing to Court.)

Q Referring to page 9 of your report, the first paragraph that isn't quoted from another source, I note

that you on the fourth line quote a title, "Forecast of Earnings as Estimated by Cities for the Year 1947 on a Corporate Basis."

A That was incorrect. That should have been the consolidated basis. That was actually the heading on that sheet, 594, but this was a lower section of the report that I used.

THE COURT: What line is that?

MR. WILSON: It's the fourth line --

THE WITNESS: Fifth line.

MR. WILSON: I'm sorry, fifth line. Where the word "corporate" appears. Should have been the word -- let me check the title, but I think it is "consolidated."

(Pause.)

MR. WILSON: Yes, in the title it's on a consolidated basis.

Q The numbers that appear in the report are which numbers? The corporate basis or the consolidated basis?

A Consolidated basis.

Q What is the source of those numbers?

A The SEC page 594 of its report, 25 SEC 575.

Q Did you make any attempt to check this analysis in any way?

A I checked it against Moody's and found that it was a very large understatement as far as the actual earnings reported in Moody's for the year 1947.

In fact, it was a large understatement of what Moody's reported for '46.

Q The Moody's figures that you referred to were greater than the figures you used here in terms of income?

A Much larger.

Q What is Moody's?

A Moody's Industrial Manual and the Moody's Public Utilities Manual.

Q Did you make any other checks on your yield calculations?

A I examined the preferred stock in light of the change in interest rates between the time that the preferred -- I mean in dividend rates between the time that the preferred was issued in the 1910 to 1930 period and the interest rates at the time of this transaction, in 1947.

In the preferred and preference stocks all had the 6 per cent dividend, stated dividends. And at the particular time that this transaction, the going dividend rate on preferred stocks was about 3-3/4, 3.75 per cent.

So it meant that whatever company had out

6 per cent preferred stock was paying a much higher than the market rate of interest -- I mean, yield rate at that particular time. And to look at it another way, if you had issued, if the company had issued hundred-dollar preferred stock on which it was paying a 6 per cent dividend, in 1947 it could have issued $150 worth of preferred stock for that same dividend, because with an interest rate of 3-3/4, just round it off and put a cushion in it, using a 3 per cent rate you could have paid a dividend, a market dividend on $150 of preferred in 1947 with the same dividend that the Cities Service Company was obligated for on the preferred and preference stock with a 6 per cent stated dividend.

On that basis it meant that for $58 million-plus in preferred stock outstanding, that the dividend that were applicable to that number of -- that many of shares could have been -- could have commanded in the market at that time 50 per cent more capital, which means that paying -- if you were paying out the same amount of dividends the Cities Service Company could have, with the same yield, have acquired $88 million worth of capital in 1947.

The arrearage was a claim that any going concern which was healthy enough to stay in business

would have considered an obligation that had to be eliminated so that the owners of the company could participate in the earnings of the company.

And under any circumstances I don't see how the arrearage could have been considered as anything but its stated amount, which was around $49,700,000. And adding that to the $88 million capital, that the stated dividend of $3,531,000 could have commanded at that time, gives a value of $137 million, as represented by what was eliminated by the transaction of 1947; the arrears, the preferred and the preference stocks of Cities Service.

Q That $137 million figure represents the sum of the arrears which you felt had to be paid and the amount of capital that the dividends Cities was paying on their 6 per cent stock could have commanded?

A That's right.

Q In 1947?

A In 1947, yes, sir.

Q Mr. O'Farrell, why did you use in your field analysis a 50 per cent tax rate, rather than whatever the prevailing rate was at that time?

A The prevailing rate was 38 per cent. And as I said, they were adjusting in the -- the Government,

through Congress was adjusting for the unusual tax rates that were prevalent during World War II. The most unusual of the rates being the excess profit rate. And as of 1947 the rate was 38 per cent.

But I thought that there was considerable risk that it would be increased, and rather than have to split hairs and justify something that was momentary as something that would be perpetual, I used the 50 per cent rate as almost not subject to dispute.

MR. WILSON: No further questions of this witness.

BY MR. CASEY:

Q Mr. O'Farrell, I'd like to clear up a couple of minor points in my mind at the outset. I don't intend to have you hopping back and forth in your report but if you would mind turning to your report which is Defendant's Exhibit C, at page 11.

A Yes, sir.

Q And I'd like to call your attention to the second sentence of the only full paragraph of that page which begins, "Excepting formal debt maturity requirements which may be cared for by refunding --" and this is the language I'd like you to concentrate on -- "about the only attachment a corporation as an entity has to its securities is in its obligations to pay interest or dividends to the holders thereof."

And I wanted to be sure I understood that what you mean there is that as far as the corporate entity, Cities Service Company is concerned, its focus on the outstanding preferred and preference shares and common shares and debentures is only as those securities call upon the company to either make payments in all events or to declare and pay dividends in the discretion of the directors, and to recognize the contractual difference between the preferred and preference

shareholders' rights and the common shareholders' rights, is that what you mean by that sentence?

MR. WILSON: I object to that question, your Honor. I don't understand it.

THE COURT: Do you understand it?

THE WITNESS: I understand it. He just questions whether I mean what I say?

THE COURT: Yes.

BY MR. CASEY:

Q And do you?

A I mean what I say, yes, sir.

Q Fine, thank you.

And also moving to page 9 of your report, which, I take it, really was the basis for the valuation here. You took, as I understand it, the forecast of earnings on a consolidated basis, and adjusted that for taxes, and then applied a 50 per cent pay off rate, and a capitalization rate of 5 per cent, is that correct, so that coming then to the value derived of $135,000,000 for the common stock.

A Yes, sir.

Q Now, I take it as an expert in the field you did more than the mathematical computations, you looked at that value and determined it was in the ballpark, is

that correct?

A I considered it a very low value but I was, you might say, stuck with it because the whole transaction was predicated on the SEC acceptance of the information that had been given to them by Cities Service to justify this recapitalization or transaction which was entirely the invention and suggestion of Cities Service. Cities Service had voluntarily made the recommendations that the capital simplification be handled in this matter, without the SEC taking any action whatsoever except to have hearings. They had amended their plan to satisfy the preferred and preference stockholders and what was done on May the 27th was what the Cities Service wanted to do. They had suggested it, amended it, put it before the SEC.

The SEC in reviewing that and justifying what they had done used the figures and -- accepted and used the figures that Cities Service had given them and these were some of the figures that they gave considerable importance to, apparently, from the way they hendled them in the report.

Q So that looking at one of the factors, the net income before tax, now if that changes, your computation changes obviously, and I would invite your attention to the same schedule, it's Exhibit G attached

to the Defendant's Exhibit A, it's the table to which counsel referred in the direct examination, using the consolidated basis, you started with the 29 million?

A Yes, sir.

Q And you treated that as before tax.

Yet, I would ask you to look at the second line in that schedule at table 9 on that page which says that this is operating expenses, other costs and taxes, indicating that this is really an after tax figure, is that correct?

A Not to my understanding.

Q The taxes that this refers to then are not income tax?

A I wouldn't think so. If they were they couldn't do anything but make any figures an understatement.

Q Then did you examine at all the underlying schedules that were the basis for this SEC report?

A I read a considerable amount of the transcript of the hearing, and I examined the information that was published in Moody's, and in Moody's they reported that in 1946, which was the year before the year that we are interested in for forecasting purposes, that Cities Service had 27 million dollars earnings after taxes, they had $6.41 per share available for dividends, I

used less than $2 a share and I thought then that I was doing it overconservatively, but it wasn't necessary to split hairs on it.

MR. CASEY: I would like the Clerk to mark this for identification Plaintiff's Exhibit No. 5.

(Plaintiff's Exhibit No. 5 marked for identification.)

xx

Q Mr. O'Farrell, did you ever see this exhibit before?

A If it was in the hearing I may have looked at it.

Q Then having looked at it, since it was in the hearing, I would direct your attention to page 1 of this exhibit and ask you to read the line third up from the bottom which says, "Income before income taxes."

A 39 million.

Q And the next line.

A Income tax $9,300,000, leaving $29,700,000 after taxes.

Q Indicating that then the figure used in the SEC exhibit and page 9 of your report was really an after tax figure.

A I will look and see again.

It may be, but I can't see it for certain

here.

It's on there but I say I wouldn't know, I don't know that the income tax was taken out here. This is a summary and if it was used, it was used in the most conservative manner.

Q Did you make the assumption that income taxes were not removed?

A I did, yes.

Q Mr. O'Farrell, could you tell us what the valuation figure would be on page 9 of your report if instead of treating the income as before tax you had treated it as after tax?

A If I took the 39 million as the proper figure instead of the 29 million here?

Q Yes, sir.

A If I were to take --

Q I am asking you to take $29,700,000 and treat it as an after tax figure. You took it and treated it -- excuse me, $29,576,000 -- you treated it as a pretax figure, and I am asking you what effect it would have upon your valuation if you treated it as what it was, an after tax figure?

A I am just using it the way I used it in the report which is to take the report tax figure, divided by

two, to get it down to an after tax figure, divided by two to get it to a 50 per cent payout.

Q I am asking you, Mr. O'Farrell, if you can make a calculation of your valuation of the value to the common stock of Cities Service of this exchange by treating 29 million dollars in round numbers as an after tax figure, and I am asking you to tell us what your valuation would be if you did that?

A Which will be not the way I did it in the report, keep that in mind. If it is an after tax figure continuing from there and taking a 50 per cent payout would be $14,500,000 and multiplying it by 20 would be $290,000,000, which is about the figure that Cities Service proved to be in value, the Cities Service stock proved to be in value in about a year.

Q Now, you used the 50 per cent tax rate -- excuse me. Strike that.

MR. CASEY: I will ask the Court to mark this document for identification as Plaintiff's Exhibit 6.

(Plaintiff's Exhibit No. 6 marked for identification.)

Q Now, Mr. O'Farrell, I ask you to identify this document, the frontispiece being --

MR. WILSON: Excuse me, did you plan to offer

Exhibit 38?

THE WITNESS: It is labeled "Economic Report Of The President Transmitted To The Congress January 1972," it looks like.

MR. CASEY: I haven't decided, Mr. Wilson.

Q I will ask you to look at the table B73, particularly directing your attention to the year 1947.

Would you read the --

THE COURT: He can read it to himself.

Q Would you read the column headed "Corporate Profit After Taxes For 1947." And then the column entitled, "Dividends."

And I ask you, Mr. O'Farrell, to tell me whether the corporate dividend rate, as opposed to the corporate total profits after taxes was 50 per cent or was it less than 50 per cent, the ratio?

A The dividends are listed as six and three-tenths per cent, I assume, it is 6.3, and the distributed profits is listed as 13.9.

Q I am sorry, 24, the total profits is the question I asked.

A 20.2.

Q Would you tell me roughly the ratio between -- Mr. O'Farrell, what dividend payout of 6.3 as opposed

to total corporate profits after taxes of 20.2, could you give us the ratio of payout represented by those statistics?

A A little over 30 per cent.

Q Did you take into account the current ratio of payout of 30 per cent or a little over 30 per cent in making your analysis?

A I don't know that that's the current ratio. I read your figures. I haven't investigated. I don't know the source and I will say that with the figures you have given me that there were roughly 30 per cent. To me they have no significance to what I am using here.

Q You used the 50 per cent?

A Yes, sir.

Q If you had used a 30 per cent instead of a 50 per cent payout, what would your appraisal have been to the value of the common shareholders of Cities Service of the removal of the preferred and preference shares?

A On the figures that I used, you would have reduced the dividend to about 4 million dollars and would have changed the valuation to around 80 million dollars.

MR. CASEY: Your Honor, I would offer in evidence, Plaintiff's Exhibit 6.

MR. WILSON: I object. There is a complete

lack of foundation for that exhibit.

THE COURT: This is put out by the Department of Commerce. You object to not having the whole report in?

MR. WILSON: We have no idea what basis those figures are calculated on. I don't remember seeing what year it was for but I assume my opponents have used the correct year.

THE COURT: It is taken from the economic report of the President this past January. The main source is the Department of Commerce, Bureau of Economic Analysis.

MR. WILSON: May I?

THE COURT: When you say 80 million dollars you are using figures which apparently are not correct since you have this listed as $29,576,000 as being before taxes when they were actually after taxes? Are you sure you mean 80 million or 160 million dollars?

THE WITNESS: The figure that we were working on then was a 30 per cent payout.

THE COURT: That's right.

THE WITNESS: Using the same figures that I have --

THE COURT: You are figuring on the basis of this being still subject to taxes and allowing 50 per cent for federal income taxes, you reduce that rounded

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figure of 13 million five -- you use the average rounded figure of 27 million reduced to 13 and a half million as being available for dividends on the common stock, but wouldn't the entire 27 rounded figure be available?

A I was answering the question on the basis that he was --

THE COURT: Assuming a payout of 30 per cent rather than 50 per cent.

THE WITNESS: That's right, sir.

THE COURT: A total annual dividend on that basis --

THE WITNESS: Would be 8 million.

THE COURT: -- would be 8 million times 20 would be 160 million dollars.

THE WITNESS: 160 million, yes.

MR. WILSON: Your Honor, the Government would withdraw its objection to the entry of 6.

(Plaintiff's Exhibit 6 received in evidence.)

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Q Now, with your analysis at 135 million as stated in your report without the changes suggested here, wouldn't you have expected the common stock to rise dramatically in price if all of a sudden it has 135 million dollars added value?

A It didn't have it all of a sudden. They were anticipating that there was going to be some change and that anticipation was a factor in the market for several years in stock in 1942 sold for two and an eighth so there was something that had brought it up in the intervening period.

Q I would invite your attention, Mr. O'Farrell, to your attachment 3 attached to your report.

Do you have it before you?

Could you tell us the nature of that attachment to the schedule?

A This weekly report on the stock prices for the Cities Service stock starting the first of 1946 and going through the date of its transaction, I think it went through the end of the week, it included the transaction. June the 6th, 1947.

THE COURT: What was the total common stock outstanding?

THE WITNESS: 3,702,000 shares.

THE COURT: 3,702,000.

Q Could you tell us the date on which the Cities Service plan of simplification was announced?

A It was announced on November 20, 1946.

Q Looking at page 1 again, the value at June 14,

1946, what was the high for that date?

A 41 and seven-eights for the common.

Q Now, I will invite your attention to page 2, and I guess the nearest date to the announcement of the plan was November 22, 1945, is that correct?

A November 22nd, yes, sir.

Q Could you tell us what the high for the common stock was on that date?

A 26 and five-eighths.

Q Now, I would ask you to look at February 14, 1947. Could you tell us the high on that date?

A 32 and five-eighths.

Q And could you tell us whether that was the high for the period 1/3/47 through 6/6/47?

A There were two highs there together, both of them the same, 32 and five-eighths.

Q They were on what dates, what was the other date?

THE COURT: 14 and 21.

Q When was the plan effective, Mr. O'Farrell?

A It was effective May 27, 1947.

Q I would ask you to look at the value at 5/30/47, and tell us what that was?

A The high that date was 31 and a half for the common.

Q And how about the low?

A The low was 28 and three-quarters.

Q Would you consider that a substantial change in the market price of Cities Service common stock?

A Between what period?

Q Between the high and -- excuse me. Between November 22, 1945 and the date the plan was effective.

A Not a particularly substantial change.

Q Now, at 135 million dollars, which is the value derived by you on page 9, could you tell us what that translates to per share of common?

A I'd have to divide it out. I hadn't divided it out.

Roughly $37.

Q Would you tell us what the average between the high and the low in 1945 was for the common stock?

A It was about 31.

Q So that really the increase in value, if we accept your analysis, as set out on page 9, represents about $5.50 a share, is that correct?

A Increase in value?

Q Yes.

A From what?

Q Well, you told us that the 135 million dollars

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value to common per share translates to $36.50, is that correct?

A 135 million.

Q $37, I am sorry.

A I said roughly 37.

Q I am sorry, 37. And the average of the high and low for 1946 was $31, correct? What is the difference then between the two?

A The difference between the two figures is roughly $5 but that isn't of significance with reference to my appraised value. This is something that had been in progress for years, this simplification. The Cities Service Company, the parent, had been a registered holding company since January 1941 and it was anticipated that during that period there, particularly in the period from 1944 on when Cities Service had elected to become a nonutility and that had been approved by the SEC, it was fairly evident that there was going to be a general simplification at sometime in its history.

Q Could you point out in your report the figures for common stock values for '44? Did you consider the common stock values in 1944?

A I considered them. I don't know whether I have them in the report.

Q Did you consider $5.50 per share a significant difference in the value of Cities Service common stock?

A I would just say arbitrarily $5 per share on 3,700,000 shares is a significant amount of money.

Q And it amounts to what in total?

A About 18 and a half million.

Q I'd like you to look at page 10 of your report, Mr. Farrell, and the third sentence of the paragraph at the top of the page, the arrears were a definite black mark, do you see that?

A How does it start? Let me read it to you.

Q The arrears were a definite black mark against standing of the company and in a prosperpous going concern ultimately had to be recognized and paid.

A Yes, sir.

Q Could you tell me how the arrears effected the company?

A The arrears effected the financial standing of the company because they had at this time practically no justification for not being paid. They had no justification for not being paid because the company had been earning a substantial amount on its common stock, besides the payment of their preferred stock, since 1940, and in the period from 1940 to 1946, a six year period, they had

increased their surplus by 111 million dollars which was equivalent to 18 and a half million dollars per year and 18 million and a half per year could have very nicely have been worked into some kind of a plan for paying the arrears, and it makes the attitude of the company to the owners and the creditors of the company somewhat suspicious when they have available money to pay a dividend on a preferred stock and don't pay it.

Q Did it interfere with the company's borrowing power?

A I don't remember that they made any effort to do any borrowing in this period in which they had these substantial earnings. I couldn't say that it did interfere and I couldn't say that it didn't because --

Q So that was not the black mark to which you referred. The impact on the borrowing power of the company was not one of your considerations?

A No, I think it was the general attitude of the company towards an obligation that you have to people that finance the company and the obligation to people that finance the company is to pay them for the use of their money, and if you borrowed the money you pay them interest and if you let them come inside the capital structure of the company on the equity side you pay them

dividends, and it is any company that is going to have a good reputation in the community is going to pay people for the use of the money if it does use their money and makes a profit on it.

Q So, I take it that your answer to the question that the black mark was the general standing of Cities Service Company in the community.

A As long as they were not earning money and they couldn't pay a dividend, they may have been able to justify the situation as it existed in this period in which they were buying up their preferred and preference stock in the open market, but after they reached the stage where they could afford to pay the dividend they had earnings so that they could pay the dividend, it looked like it was an abnormal situation, not to be paying this dividend.

Q Well, it looked like to whom?

A To anyone in the investment community.

Q And I am still trying to find out what impact on the Cities Service Company this black mark you see had. Is it anything beyond --

A The impact it had on the Cities Service Company at that time was the impact it had on their owners. They couldn't get any of the earnings of the company because the arrearage stood between them and the earnings.

Q Now, are you familiar with Defendant's Exhibit S filed in this proceeding, which is the report of Mr. Goulston, are you familiar with that report?

A I haven't read it yet.

THE COURT: What connection does the common stock have to the dividends paid when the arrearage has been removed?

THE WITNESS: They had none except through their supposed control of the management, with a widely dispersed ownership like that when there was almost 300,000 stockholders and the average holding of stock was between 10 and 15 shares per stockholder. The only assurance that I would have is by some mass proxy effort, they would have a committee that would get control of the management and make them pay it if they weren't inclined to do so.

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THE COURT: You are talking about a 50 per cent or a 30 per cent payment. That presupposes that there is another situation existing with respect to the particular company which they could not say anything.

THE WITNESS: I agree, sir, that is true. But I believe in my study of the hearings before the SEC and the records of the company up to that date they were almost in a position where they were forced to pay the dividend --

THE COURT: A dividend.

THE WITNESS: A dividend, yes, sir.

THE COURT: But not necessarily 30 per cent.

THE WITNESS: No, sir.

Q When you talk about yield, Mr. O'Farrell, how do you define that term, yield?

A That is the return you obtain on your investment on -- generally on an annual basis.

Q Could you tell me what the yield on the Cities Service preferred and preference shares were in 1946 and 1947?

A Zero.

Q And your valuation approach is predicated upon yield; is that correct?

A To a large extent it is. I was satisfied at

that time that they could certainly pay a minimum of $6,750,000 into the future and that would support $135 million value for the company on a yield basis.

Q I am talking now about the preferred and preference shares which were the securities acquired by the company.

A The acqusition of those securities, the removal of those securities by that acquisition removed the barrier that kept the common stockholders from receiving their dividend.

Q On page 10 of your report the yield analysis is directed only to the preferred and preference shares; isn't that correct?

A I don't quite understand your wording. The preferred and preference shares standing on their own feet had without the SEC giving them this transaction, to give value to them, the preferred and preference shares per se didn't have the value that I have indicated was inherent in the common stock through the removal of them.

Q But on page 10 again you are talking about value of the preferred and preference shares based on yield; isn't that correct?

A I am on this one figure here, I am. The

$88,035,000.

Q Looking at the earnings statement at the bottom of page 10, Mr. O'Farrell, could you tell us the income before taxes and fixed charges for the year 1946?

A $51,248,940.

Q And for 1947?

A $74,059,218.

Q For purposes of your analysis did you assume that on May 27, 1947 the actual earnings for the year '47 would be predictable?

A I didn't assume they'd be predictable, but I assumed that at that time you could get a good guess at them. But I didn't say that they were predictable in that you would be able to work them closely.

I would say, looking at the $74 million, it might have been $65 million, might have been $80 million. But it was some large figure that was not out of keeping with the years that went before it.

Q In 1945 what was the income before taxes?

A $37,720, 491.

Q Mr. O'Farrell, looking at a company whose earnings in two years doubled, how would you expect the common shares to react, in price?

A Well, you have to qualify that with the recog-

nition that 1945 was an abnormal year. It was the year in which they allowed them to accelerate this wartime depreciation and amortization. And one of the subsidiaries of Cities Service, I believe threw in $18 million worth of amortization in that one year. And there was an artificially depressed earnings before fixed charges in this year.

I didn't work it out in detail, but I would estimate that 1945 was truly probably between $46 million and $51 million between the 1944 and the 1946 figure, if it hadn't had that artificial deduction.

Q I will accept the year 1946. Could you tell us the percentage increase in earnings between '46 and '47?

A I'd say 45 per cent.

Q How would you expect the common stock price to react with a 45 per cent increase in earnings?

A If it was suddenly thrust into the market, it might cause a sudden reaction. But I believe from the record that Cities Service had shown from 1940 to 1946 that a substantial increase was anticipated and discounted in the pricing in the marketplace.

Q Let's go back to 1944, then.

Could you tell us what the income before taxes and fixed charges were in 1944?

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A $46,825,693.

Q What per cent increase would the figure for 1947 be over 1944?

A It's over 50 per cent.

Q It's almost a hundred per cent, isn't it?

A No. The increase was about $28 million on $46 million. That would be about a 60 per cent, maybe.

Q On the other hand, 1941, what was the income before taxes and fixed charges?

A It was $50,276,503.

Q So there was no real continuing pattern of increase in earnings between 1941 and 1947, was there?

A Not in this level on the earnings, because this is before the fixed charges and the fixed charges were continuously changing during this period.

Q How would you have expected, then, the common stock to react with the increase of 60 per cent between 1946 and 1947?

A If it were all applicable to the common stock it might react violently. But this was not applicable to the common stock. This was before the fixed charges and it was the -- the common stock got what was left over, and after taxes, too.

Q But this is really the best guide for deter-

mining the health and prospects of Cities, isn't that correct?

A It was a good guide for indicating the flexibility they had in the choice of the capital instruments that they would use. They had a big coverage for fixed charges if they want to use them, bond indebtedness, or they could carry down after taxes, they could take no bond interest out of it and carry down after taxes and still have a large amount there. But it was -- what went to the common was predicated on what came out before that.

Q Let me ask you:

What effect on the common stock would you have expected from these earnings figures? Would you have expected to go up dramatically?

A No, I wouldn't.

Q It would have no effect on the common; is that what you are saying?

A I am questioning the "dramatic."

I am saying there would have been no change in the bond indebedness and your earnings before fixed charges continuously gone up, you would anticipate there would be much more left for the common. And the common would probably increase in price, as it stood more chance

of profiting in the operation of the company.

Q But it did not?

A That may be. It varied in price, but that may have been due to reasons entirely different from what is shown here by the earnings before fixed charges.

Q I am just talking about what you have in your report.

A That was put in concerning the fundamental health and prospects of Cities. This was put in before the capital effects on Cities, indicating that they might deliberately change the capital effects, but this is the fundamental they had to work with:

The earnings before fixed charges.

Q So given the percentage and increase in earnings you would have expected the common stock to go up, correct?

A If there had been an increase in earnings that could be carried down to the common, the normal thing would be to expect it to go up.

Q The critical change in the capital structure was the introduction of the debentures; isn't that correct?

A No. I think the critical change was the change in the capitalization rate that was taking place

in this period, when you were getting rid of 5 per cent debentures and issuing 3 per cent debentures. That was the thing that had the most effect. They were changing their structure quite a bit by taking cash, selling property at a considerable profit and taking cash and accumulating cash that they weren't paying out in dividends, and using that to reduce capital.

But I think throughout that the significant change was in the reduction in the interest that they had.

Q Using the change of 5 per cent debentures being paid off, and 3 per cent debentures being substituted, you would expect, would you not, that the common stock would move up.

A If that were the only thing that affected us, if you were taking an issue of 5 per cent debentures and exchanging them for 3 per cent debentures, you should have more available for the common stock, all other things being equal.

Q On the other hand, with a yield ratio of senior securities at zero, the imposition of fixed charges payable in all events would have what kind of an effect on the common stock?

A It wouldn't have any effect on it that could

be isolated to that particular situation, as long as the common stock couldn't profit from what was going on. If there was no yield on the senior stock there was no dividend could be paid on the common.

Q What is the yield on IBM, do you know?

A I think it's around 2 per cent now.

Q Pardon me?

A Around 2 per cent now.

Q Pardon me?

A Around 2 per cent. A little less than that. It sells around $400 and it pays $6, something like that.

THE COURT: Let me ask you, I don't want to change the train of thought here, but you talk about the value, the corporation's value to the stockholders, the common stockholders. On that basis the paying off of the cumulated arrearage, you say, was of benefit to the common stockholders because that would permit them to anticipate possibly the payment of dividends on the common stock. But the payment of the full premium, didn't benefit, it was not necessary to benefit the common stockholders, because if the arrearages were paid up, it wasn't necessary to call the stock in order to have this benefit to the common stockholders.

THE WITNESS: The preferred stock at that time

was receiving a dividend which would be the equivalent of 5 per cent, would have been the equivalent of better than $70 million worth of common stock. And that much --

THE COURT: Well --

THE WITNESS: And added on to the arrearage --

THE COURT: You end up with --

THE WITNESS: Better than 115 million.

THE COURT: Didn't the debentures pay close to --

THE WITNESS: Pretty close to $3,500,000. That you were getting rid of the arrearage and the preference with that.

THE COURT: I understand that.

THE WITNESS: And on the basis of the value placed on the yield basis on the preferred and preference of $88 million, added to the arrearage it ran substantially above the $115 million that they were obligating themselves for at that time.

THE COURT: /I am talking about this what you testified to earlier, starting your testimony when you mentioned what had to be gotten out of the way so that the common stockholders would have a chance, since the company was the common stockholders'.

THE WITNESS: Yes, your Honor.

THE COURT: And everything follows so far as

the premium payment was concerned.

I think we will have to adjourn to tomorrow morning at 10.30.

(Adjourned to Wednesday, July 19, 1972, at 10.30 o'clock a.m.)

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CITIES SERVICE CO.

vs. 67 Civ. 4606

UNITED STATES OF AMERICA.

New York, July 19, 1972;
10.30 o'clock a.m.

(Trial resumed.)

- -

J O H N O ' F A R R E L L , resumed.

CROSS EXAMINATION (Continued)

BY MR. CASEY:

Q Mr. O'Farrell, in your testimony yesterday you stated you reviewed the SEC files on the plan of simplification hearings, is that correct?

A What I said were the pertinent parts of it.

Q You also testified that you relied upon a pro forma table of income for 1947 which is set out in Exhibit G, attached to Defendant's Exhibit A, do you recall that?

A I don't remember the identification.

That is the one.

Q Could you tell us, please, what document contains that pro forma table attached to Defendant's Exhibit

A as Schedule G?

A I have learned since I used it, since yesterday, that the source of it was in Exhibit 28 in the hearing, in the papers connected with the hearing in late '46 and early '47.

Q And you would consider that pertinent, I take it, to your review of that table, that Exhibit 28?

A I don't know what you mean pertinent. If that is the source of this and I am not absolutely certain it is because they have changed the figures, but it appears to have been the source.

Q And you would have looked at the Commission exhibit which would have been the source in your use of that table, I take it?

A At the time I used the table, I didn't have the source information available.

Q I would show you a document marked for identification as Plaintiff's Exhibit 5 and ask you to identify it.

A The title on it is "Cities Service Company earnings and cash estimates," and it is Commissioner's Exhibit 28, I assume, from the hearing.

Q I ask you, Mr. O'Farrell, if you have reviewed this document in connection with the preparation of your testimony?

A I can't remember any review. I saw the hearings transcript and papers, but I can't identify this document as one that I reviewed at the time.

Q I ask you, Mr. O'Farrell, to examine the schedule on page 1 of the document marked for identification as Plaintiff's Exhibit 5.

Could you tell us what that schedule is?

A It is headed "Estimated Income Account for 1947."

That is for Cities Service Company and subsidiaries consolidated.

Q I would ask you to review this schedule and the Table 9 of Exhibit G, attached to Defendant's Exhibit A.

MR. WILSON: I would like to know whether Mr. Casey plans to put this in?

MR. CASEY: I intend to put it in.

MR. WILSON: Can we offer it now so it is part of the record?

MR. CASEY: Your Honor, I would offer in evidence Plaintiff's Exhibit 5.

MR. WILSON: May I see it for a moment.

MR. CASEY: Surely.

MR. WILSON: Your Honor, I have a problem with

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this exhibit. As I understand it, the source of this, or the original filing of this was with the SEC in the course of that hearing.

MR. CASEY: Yes.

MR. WILSON: This is Exhibit 28 in that hearing?

MR. CASEY: Yes.

MR. WILSON: Do you know whether there was a revised Exhibit 28 filed?

MR. CASEY: If you direct your question to Mr. Robinson --

MR. ROBINSON: I am not sure. This is what came out of our files as the exhibit.

MR. WILSON: Your Honor, I have the original exhibits here.

MR.CASEY: Would you offer those?

MR. WILSON: I was planning to introduce a copy of this, if you will take my representation this is a Xerox copy of 28 revised as it appears in the record, and I would suggest that we use that.

MR. CASEY: Fine.

THE COURT: It may be admitted.

(Plaintiff's Exhibit 5-A was received in evidence.)

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BY MR. CASEY:

Q Mr. O'Farrell, I will ask you to look at the schedule on the first page of Plaintiff's Exhibit 5-A and ask you if you are satisfied that that exhibit is the source of the table on which you relied?

A The SEC in its report grouped a lot of the figures never used, so it is practically impossible to identify what they used with what they used here.

In the final figure, the SEC had a net income of $29,576,000. In the final figure in the exhibit being reviewed, there is a figure of $29,576,000, which is the same thing.

The net income on this figure is after taxes. The net income on the other figure is shown as the last figure -- is the next figure after total fixed charges, which to me was separate as net income before taxes after fixed charges.

Q Mr. O'Farrell, turning to Defendant's Exhibit C, which is your report.

Do you have it in front of you?

A Yes.

Q If you would look at the first page, could you read the symbols at the top, at the upper lefthand corner of that page and explain what they are?

A TIEV-JO'F over RL-9795.

Q Could you tell us what the initials on the first line TIEV-JAO'F stand for?

A In the Internal Revenue Service for simplicity, each of the activities is identified by symbols and the symbols ordinarily indicate the line of authority from right below the Commissioner down to the particular activity itself.

The "T" is for technical.

The "I" is for income.

The "E" is for engineering and the "V" is for valuation. Which means, the section in which -- the last three letters are my initials -- but the section in which I am assigned is under the Assistant Commissioner Technical in the Income Tax Division and Engineering and Valuation -- Engineering and Appraisal Branch in the Valuation Section.

The letters and figures under that, RL-9795, that is a refund litigation indentification number for the Cities Service Company case.

Q I take it that anyone assigned to your branch and division or activity, would the initials TIEV be constant?

A Anybody in our section.

Q The only thing that would change would be the initials of the person preparing the report?

A Yes.

Q I will ask you to turn to the last page to get some of this housekeeping out of the way here and ask you -- this is page 11 of Defendant's Exhibit C, and ask you to read the legend at the bottom lefthand corner of the page starting with "Reviewed by".

Do you see that?

A Yes, reviewed by Jeffrey J. Taylor and typed out Jeffrey J. Taylor under his name signed.

Q Then at the bottom of the page, again there are initials and numbers.

Could you read those and tell us what they are?

A They are not on my copy.

Q I am sorry.

THE COURT: They are not on the exhibit. This is the exhibit which was marked in evidence.

MR. CASEY: Your Honor, working from the copy of the report furnished us by the defendant here, we seem to have come up with an item that is not on the original report and with permission of counsel, I will read into the record what I have on your copy.

JO-F/BAM, and under that 4/17/72.

A That is my initial and the typist's initial and the date on which it was typed.

Q Could you tell us who Jeffrey J. Taylor is?

A He is the section chief in the valuation analysis section.

Q When it states that he reviewed your report, could you tell us what that review encompassed?

A The review in some organizations may be one thing and it may be another and it may be another thing in another organization.

In our organization, the review is just a check to indicate whether the person has made any particular blunder inconsistency with what is required by laws, regulations and revenue procedures. There is no attempt whatsoever to review him on his judgment but there are certain things covered by statute that have to be credited when you are making valuation. For instance, depreciation is a statutory matter and a person who is doing a valuation can ignore the fact there are statutory limitations to the view you can take a depreciation.

So, mainly, this is a review to catch anything that would be glaring and would be an embarrassment to the Internal Revenue Service if it were published. For instance, a gross misue of a word there, ignorance

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of the import of a certain word. An intemporate statement. Nothing is going to go out that will embarrass the Service if the chief has the opportunity of checking.

BY MR. CASEY:

Q Is it within the scope of the review to be sure that the report in this instance comports with the Revenue Service's overall position in matters of similar nature?

A There is no attempt to be consistent in this report and another report, if that's what you mean. The valuation reports are judgment reports. The appraiser reviews all the facts, he comes to a conclusion and the conclusion is ordinarily an expression of opinion.

Now, the reviewer can never change that because it isn't his opinion, it's the appraiser's opinion, but he can certainly indicate to him that in a certain tax court decision or a certain district court decision, the emphasis was given to other factors affecting this value; has he considered those. If he doesn't say he has considered them, why, it would be well to consider them before he makes -- to confirm his decision -- I mean, his opinion, but there is no effort to it as an appraisal. No one tells anybody else that this is not a proper judgement.

I have reviewed cases where I didn't agree with them at all, but I wasn't the appraiser.

Q Now, in the -- you will recall Revenue Ruling

65-13. Do you recall that revenue ruling?

A I can't recall it by number.

Q It is the revenue ruling which said, in effect, that the taxpayers could not use open end straight line or sum of the year's digits depreciation -- strike that.

The taxpayers could not use open end sum of the year's digits or straight line depreciation multiple asset accounts, and at the same time elect the guideline procedure which was set out in 62/21.

Do you recall the substance of that?

A No, I don't, sir.

Q Well, let me ask you a hypothetical:

If the Commissioner takes a position in a published revenue ruling that a taxpayer is not entitled to use certain depreciation techniques, and at the same time certain group accounting, would your reviewer be certain that the report did not use those techniques itself?

A If he were familiar with them he might. I mean, those would be factual parameters that would have an influence on the appraisal.

Q Certainly, if he knew that it was the published position of the Commissioner that this type of accounting could not be used for depreciation purposes in these circumstances, then the reviewer would delete that from

the report, I take it?

A If he were reviewing the matter concerning depreciation he would be guided by any factual limitation on the taxpayer or what other party he was reviewing in this particular situation.

Q Or policy, I take it?

A Well, I wouldn't go so far as to say policies.

Q Could you tell us what changes Mr. Taylor suggested in this report, Exhibit C?

A I don't know. I don't remember any changes. I asked him to prepare the Exhibit No. 8 for me, and he did, because he's a CPA and it was an accounting exhibit, and so he prepared it so that I would have an authoritative basis for the accounting setup that I was using.

Q Now, when you refer to Exhibit No. 8, are you referring to an attachment No. 8?

A Yes, sir.

Q To your report?

A Yes, sir.

Q So that this is really Mr. Taylor's exhibit which goes into a part of your consideration in this case, is that correct?

A No, It's really my attachment, but Mr. Taylor under my direction, even though he is my superior, prepared

it in his capacity as an accounting expert, a CPA, one who was perfectly familiar with what he was doing. I am not an accounting expert, I am not a CPA, but I wanted an exhibit that wouldn't be questioned on accounting principles.

Q Could you tell us, Mr. O'Farrell, how attachment No. 8 was reflected in your report and in your conclusions?

A I said in the report, "It is generally recognized in corporate securities analyses that the company record and historic trends are the best guide to answering such questions as -- "

Q Could you tell us what page you are reading from?

A Sir?

Q What page are you reading from?

A This is on page 10.

"A question may be raised concerning fundamental health and prospects of Cities. It is generally recognized in corporate securities analyses that the company record and historic trends are the best guide in answering such questions. The following list shows Cities consolidated net income before fixed charges and taxes in 1941 to '47 period."

Then I put in a table of income before taxes

and fixed charges which is taken from the bottom line of attachment No. 8.

Q And that's the only place in your report to which you make reference or in any way rely upon attachment No. 8?

A To the best of my memory that's the only place I mentioned it.

Q On page 10 again of your report, could you enlighten the Court as to the source of the footnote? Did you write that or did Mr. Taylor? The double asterisk.

A I wrote that.

Q Thank you.

Now, if you would turn to page 2 of Defendant's Exhibit C, Mr. O'Farrell, I would invite your attention to the first full paragraph on page 2 which begins, "As part of the reformation" -- do you see that?

And particularly to the last sentence of that paragraph beginning, "As the preferred"-- would you read that sentence, please?

A "As the preferred and preference stocks were deep in dividend arrears which blocked common stockholders' access to the Cities' replenished treasury, Cities itself was also interested in a capital reorganization that would remove both the senior stocks and their awkward arrears."

Q Could you explain what you mean by that sentence, Mr. O'Farrell?

A Cities was the one that proposed this plan, and they proposed a plan which, without a cash outlay on their part, would remove the arrears and remove the preferred and preference stocks, so I have to conclude that they were interested in that, it was their own plan that was being proposed, and there was no doubt that the arrears were an awkward situation in any corporation which was interested in being of benefit to its owners.

Q Are you testifying here, Mr. O'Farrell, that Cities Service wanted to get under the SEC umbrella for this purpose?

A I wouldn't know to my own knowledge but I would conclude that it might be a reasonable thing for them to have felt that this was a good time to get out of this situation without putting out any cash.

Q When was this SEC procedure first available to Cities Service?

A I assume any time after the Public Utilities Holding Company Act was passed in 1965.

Q Excuse me, '35?

A '35, pardon me.

Q And could you turn back to page 1 of your report

and explain why it was that Cities Service filed for exemption? If you will look at the last paragraph on the first page of your report, the third line, would you please read the first sentence of the last paragraph on that report?

A "Cities in three of its sub-holding companies (Cities Service Power and Light Company, Federal Light and Traction Company, and Arkansas Natural Gas Corporation) after filing petition for exemption from registration under the Act which was denied by Securities and Exchange Commission (Referred to as SEC or the Commission) on December 23, 1940, registered as a holding company under the Act on January 29, 1941."

Q Does that indicate to you the desire of the Cities Service Company to rush head-long into the protective arms of the SEC?

A This is before there was the likelihood that the SEC would make them simplify. They were trying to stay outside of the influence of the SEC for -- the influence of the SEC on any of their corporate activities at that time. After December 23rd, 1940, when the SEC denied their request for exemption, they knew that they were going to have to be guided by what the SEC thought was proper under the circumstances.

Q At what point in time would companies potentially covered by the Public Utility Holding Company Act realize that the Securities and Exchange Commission would require simplification of their corporate structures?

A I don't know. I couldn't identify the date, but I believe that any time after they registered as a holding company, they could have become aware that the SEC was emphasizing corporate simplification.

Q And they would not be aware of that before they registered? It wouldn't be common knowledge.

A I don't remember historically whether the SEC had handled enough of these plans to have indicated to the public and to the public utilities what its attitude would be, but I am confident that before the plan was proposed on November 20, 1945, that the Cities Service people and the other people in the public utility field should have realized that the SEC was emphasizing corporate simplification.

Q It is also quite possible that the people in the corporate field would have recognized the SEC's emphasis on corporate simplification any time between 1935 and 1937, isn't that right?

A I wouldn't know for certain but I wouldn't believe so because I don't believe the SEC policies

had become evident by that time.

Q But you don't know?

A I am just giving you my opinion.

Q I would like, Mr. O'Farrell, for you to look at the top of page 2 and the first complete sentence on that page, starting, "The first plan."

Could you read that sentence to us?

A "The first plan was merely a gesture on the part of Cities and it, under prodding and direction of the Commissio slowly proceeded to divest itself of its public utilities properties and concentrated its corporate activites in non-utilities industries, preincipally the oil and gas business."

Q Did you review the first plan proposed by Cities Service?

A I read the summary of it.

Q Did you review any of the corporate records which would reflect the feeling on the part of Cities Service that they should make only an empty gesture?

A I didn't say that they had the feeling they should make an empty gesture. That was my conclusion concerning the plan they presented.

Q So you would amend that sentence, I guess, instead of stating flatly that the first plan was merely a

gesture, that looking at the summaries of the first plan you concluded it was merely a guesture, is that correct?

A No, I wouldn't have to amend the sentence. I think the sentence speaks for itself. I am using the words, "empty gesture." I didn't say Cities Service made an empty gesture. I am saying it was an empty gesture what they did make.

Q Now, I would invite your attention to page 4 of Defendant's Exhibit C, and in the first paragraph of the text under the table which appears at the top of the page, if you will read the second sentence of that paragraph for us beginning, "Cities was paying."

A "Cities was paying 5 per cent on its debentures and was obligated to pay 6 per cent on its preferred and preference stock so it was highly advantageous for it to refund its debt and senior equity securities at 1945-1947 market yield rates."

Q Did it, in fact, refund its debt existing on that date or did it pay it in cash?

A Well, in substance it refunded it because they started out with a million -- 1.5 million dollars of debt before the plan, and they ended up with 150 million dollars in debt after the plan, and then as the plan progressed

they reduced that to roughly 90 million dollars in debt, so far as the corporate structure was concerned, there was no great change in the debt situation; it was what would be normally considered a refunding if it had stood on its own feet alone.

Q Well, isn't it your understanding of this case that the 3 per cent debentures were issued in exchange for the preferred stock and only for that purpose?

A They were part of a plan which was used to retire both 5 per cent debentures and to eliminate preferred and preference stocks and arrearage.

Q To whom did the new 3 per cent debentures go when they were issued?

A They went to the holders of the preferred and preference stock.

Q And to whom did the 40 million dollars in cash go?

A It went to the holders of the 5 per cent debentures.

Q So the 5 per cent debenture was not refunded in the ordinary sense of the use of that word, isn't that correct?

A Well, inside of the corporation, before the event, were debentures,cash and preferred and preference stocks. After the event there were debentures only.

Q If a 5 per cent debenture holder wanted some

part of the new 3 per cent debentures, was he entitled to that or was his option solely cash?

A Well, the consideration given for the 5 per cent debentures was cash.

Q So, we are talking really, are we, of refunding the senior securities, the preferred and preference shares?

A Maybe we are talking about different things. You are talking about it apparently from the standpoint of the holder of the debentures and I am talking about it from the standpoint of Cities Service, that they start out with 5 per cent debentures, they end up with 3 per cent debentures, which is tantamount really to a refunding operation.

Q Well, is the usual refunding operation limited to a floating of new debt to retire old debt?

A That's generally what they think about when they talk about a refunding operation.

Q As a security analyst, when senior equity securities are replaced by debt securities, do you regard that as refunding?

A No, that's ordinarily an exchange.

Q Now, the balance of the paragraph refers to the retirement of the debentures with cash, and the sale of the interest in Ohio Public Service, Toledo

Edison, Federal Light and Traction Company.

I will ask you, Mr. O'Farrell, could Cities Service wholly outside the plan, if the SEC had never asserted jurisdiction, could Cities Service have paid off the debentures with its 40 million in cash?

A I'd assume it could. I don't think there is anything to keep it from it.

Q Could it have sold any assets it chose to sell and apply the proceeds of sale to the reduction of debt without a plan?

A Yes, sir.

Q Could it have called a preferred stock without a plan?

A And paid the redemption price plus the arrearage.

Q Would you please refer to page 8 of Defendant's Exhibit C, particularly the last sentence of the first paragraph on that page, beginning, "Consequently the worth" -- could you read that sentence for us, please?

A The last sentence of the first paragraph?

Q Right.

A "Consequently, the worth to the company was not an element in the approval of Cities' plan and plans of like companies."

Q I would ask you is "worth" to the company a value usually derived in and considered by security analysts?

A Sometimes it is. I would say that a situation like this is rather unique from the valuation standpoint where you are only considering the value to the company of the removal of part of its corporate securities.

Q Now, in your experience, except for this case, have you ever had occasion to derive a value stated to be, "worth to the company"?

A That might come up in almost any valuation because the buyer of any property is certainly interested in the worth of it to him and the price he will pay is a reflection of that worth to himself.

Q Now, in connection with the statement of values of securities and equities generally, have you ever used the measure, "worth to the company"?

A Well, there are other words that can be used in place of the "worth" there, but the import of them would be practically the same as if you would use "worth." I don't know that I can identify the use of the word "worth" but the situation would be one in which you could use the word "worth," the advantage to the company, the economic advantage to the company, or the financial advantage to the company or the convenience

to the company that was involved in this particular transaction. Those things could all be considered as a worth to the company.

Q In fixing the value of preferred or common stocks do you look to "worth to the company" in establishing value?

A Well, it's a play on words, but "worth" and "value" in a good part of these situations are the same thing.

Q Well, generally speaking, in seeking to appraise a value of a security, a preferred stock, you look to what criterion?

A You look to a lot of factors in valuing common stock. In a situation like the evaluation of a common stock I would think that "worth" and "value" would be practically synonymous.

Q And when you say value in appraisal, you are talking about fair market value, is that correct?

A If you are doing it for the Internal Revenue Service, you are usually talking about fair market value, though you might be doing a valuation in which there is another value, insurable value, something like that which might be involved.

Q In not talking about anything except the value of preferred or common stocks, do you look to fair market value or to value to the company?

A If they request fair market value, you get fair market value. If they request something else, you get that.

In most of our appraisals in the Internal Revenue, we are dealing with fair market value but we are always dealing with fair market value and in this instance, we were not dealing with fair market value as a request. We were trying to define a value to the plaintiff.

Q So it would not surprise you that the Securities & Exchange Commission does not use value to thecompany in its appraisal of the fairness and equity of a proposed exchange; is that correct?

A I don't believe that they treated that at all,

of the value to the company, in the SEC.

Q Do they, however, look to a measure that could be denominated, worth to a junior debt or equity security in analyzing the plan looking toward its approval or disproval?

A They use some kind of a phraseology that brought equity into it and they were thinking in terms of equitable exchanges or equitable transactions or situations where equity was the guiding principle and they were not dealing with the values in the manner in which the appraiser ordinarily deals with it.

Q Would you accept fair and equitable as the SEC standard here?

A I believe that was the term they used.

Q In applying the fair and equitable standard, did the Securities & Exchange Commission look to the various classes of securityholder, debt and equity?

A They drew their conclusions concerning each of the securities in which they had something to do with in this particular simplification. I mean, if there were three different kinds of securities, they would consider each one of them separate and their interest was in seeing that each of the three received equitable treatment.

Q From the standpoint of the holder, correct?

A I believe that they were also thinking of the company itself and what I remember of the philosophical concepts that were developed in this series of events, multiplicity of plans that they passed on, at least it was concluded that they were giving concern to the companies themselves as separate from the stockholders and the debtors -- I mean the creditors in the company.

Q So it is not an accurate statement to say that worth to the company was not one of the SEC criterion, is that what you are saying?

A I am not saying that. I am saying they were thinking of the future of the company at that time as well as what was taking place between the company and the individual stockholders.

Q In applying the fairness and equity standard, did they apply that to the company or did they apply it only to the holders of the securities?

A The fair and equitable standards were apparently applied in seeing to it there was an equitable treatment between different securityholders.

Q So that the SEC recognizes the difference, for examples of the interest of the company, the interest of the debt holder, the common stockholder and the preferred

stockholder, is that correct?

A Would you mind repeating that, I didn't quite get the drift.

MR. CASEY: Would you read the question.

(Question read.)

MR. WILSON: I object to the question, your Honor. This has gone pretty far afield. The witness is not here as an expert on what the SEC's legal position was.

MR. CASEY: He predicated his report on what the SEC does.

THE COURT: I will permit him to testify. I don't know how relevant it is, though.

A I think that they give consideration to each one of them separately and each one together.

Q Could I ask you to turn to page 9 of Defendant's Exhibit C.

The first paragraph, the first full paragraph on the page beginning after the quote, would you look at the third sentence, I believe it is, starting with "As a holding. . ."

Do you see that?

A In the first paragraph?

Q The first full paragraph. It is after the

quote. It is eight lines up from the bottom of that paragraph.

A Yes.

Q Could you read that sentence, please?

A "As a holding company primarily, Cities could have paid out a high percentage of those earnings, but for conservatism assuming conventional low payout of 50 per cent, the total annual dividend would be $6,750,000."

Q Could you explain what you mean by "as a holding company primarily"?

A Cities Service Company was a holding company and if you had been considering what Cities Service Company itself had available, it had available moneys as a holding company and it didn't have to keep a large reserve. It was kind of a vehicle between the operating companies and the stockholders for the transmission of earnings of operating companies to stockholders of the holding company.

So, it is usually recognized in financial analysis that holding companies need to retain just a token amount of what they received so they can pay out ordinarily 90 per cent or more of the earnings that they have after taxes.

But, in this particular instance, the Cities Service was being considered in the consolidated sense and in that sense, it was a large operating company and it couldn't pay out, at least conventionally, a great amount of their earnings like a holding company.

So, I used an estimate of 50 per cent of their earnings as a proper payout for them and the circumstances in which they were at that particular time.

Q The very last sentence of that same paragraph, beginning "Using the company estimates," Mr. O'Farrell, would you read that?

A "Using the company estimates as apparently accepted by the Commission, this $6,750,000 was a reasonable minimum yield that the common stockholders could anticipate from removal of the 'barriers' presented by preferred and preference stockholders and their dividend claim."

Q This yield you talk about is pertinent not to Cities Service Company but to Cities Service common stockholders, is that correct?

A It is pertinent to both of them. One pays it, one receives it.

Q The reasonable yield to which you refer was the yield to the common stockholder, correct?

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A Well, the yield is normally thought of of what return you received on your investment but also the term is used by the people that pay it also.

Q How do you use it here? You said yield to common stockholders.

A Yield to common stockholders was the way it was used in that particular sentence.

Q The second sentence of the last paragraph beginning at the bottom of page 9 and carrying over to page 20, the bottom of page 9, the word "However, using Cities' own projections. . ."

Could you read that sentence for us?

A "However, using Cities own projections of earnings and a low payout ratio, the activation of the plan and release of its common from burden of the senior stock dividends and barrier of dividend arrears had, on a potential yield basis, a current value of $135 million to Cities common stockholders, for which Cities was corporate alter ego, proxy, vehicle and instrument."

Q Could you explain that sentence to us?

A The first part of the sentence refers to the capitalization of the annual yield --

Q I am sorry, I don't want to burden you with that. I am primarily interested in that portion of the

sentence which says, "A current value of 135 million to Cities common stockholders for which Cities was corporate alter ego, proxy vehicle and instrument."

Could you explain what you meant by that?

A The Cities was a financial projection of the risks and the aspirations and anticipations of their common stockholders within the limited range in which Cities Service operated and within the limited range in which they had risked their capital and Cities, as it stood, was a piece of paper put out by some Secretary of State of some state and gave it a right to operate under the laws of that state as an artificial person. But, in actuality, it was a group enterprise that had been formed by the common stockholders and they took the risk and they expected the gains from the enterprise.

Q So they are one and the same, in other words?

MR. WILSON: I object. The witness clearly did not finish his answer.

Q I am sorry, I didn't mean to interrupt you.

A And, as I said, in a limited field, which was confined to the amount of money they have put up in the operating parameters guiding Cities Service, it was merely their expression in the industrial world and had no particular meaning to others as a vehicle.

Q So they were one and the same, the common stockholders and the corporation, they were the same?

A If you had to identify the Cities Service with any personalities, it would be their common stockholders.

Q In your opinion, the common stockholders and Cities Service is the same?

A When you speak of what is good for Cities or harmful for Cities, you are fundamentally talking about what is good for the common stockholders or harmful to the common stockholders within the limits in which they were involved.

Q In other words, they are one and the same, in your opinion?

A Substantially so.

Q What is a dividend, Mr. O'Farrell?

A A dividend is a payment of a corporation to the stockholders, usually in a stated annual amount but it may be paid monthly, quarterly, semi-annually or annually.

Q What is the source of dividends?

A It is in the earnings of the company outside of all the obligations of the company.

Q The earnings of the company are taxed to the company?

A That would be one of the obligations that would come out of it before it was available for dividends.

Q And the dividends representing what is left of those earnings and available for distribution and declared would be taxed to the stockholders?

A Yes.

Q If the corporation realized a capital gain and paid a capital gain tax and distributed the proceeds of that sale out as part of a dividend, would it be taxed a gain to the stockholders?

A No.

Q It would not be taxed a gain to the stockholder?

A No.

Q Are you testifying that if Cities Service sold assets for consideration of $5 million for which they had an adjusted tax base of a million dollars and realized a gain of $4 million and reported the gain and put the balance in its treasury, that the stockholder who received a dividend out of those funds would not be taxed; is that correct?

A I don't know what the tax rules in detail were at that time, the tax laws and regulations.

If you returned the proceeds from the sale of capital, it is a capital return and if he has returned

a gain on his investment, he has to pay a capital gain on it.

There are several conventions that can be used, apparently, and I don't know that it is clear in all periods of their operation of the Internal Revenue laws that you would pay on gains as you received them or paid on gains after you have obtained the full return of your capital investment.

So, I couldn't say at that particular time what treatment would be given capital gains.

Q Looking at it today, assume for purpose of this question that Cities Service sold assets, $4 or $5 million realizing a $4 million gain and paying the applicable capital gains tax on the sale?

MR. WILSON: I object to the question.

THE COURT: I thought we were interested in 1947, 1946? It is interesting.

MR. CASEY: Your Honor, the witness has testified he doesn't know what the tax law was applicable to this kind of a transaction.

THE COURT: I don't believe he was called as an expert on tax laws. He was called as an expert on valuation. I may be wrong.

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BY MR. CASEY:

Q Mr. O'Farrell, do you know whether a sinking fund provision was required under the 3 per cent debentures which were issued in exchange for the preferred and preference shares here?

A Yes, sir.

Q Was there a sinking fund?

A There was.

Q What was the amount?

A A million and a half a year, I believe.

Q Did you reflect the deduction of available earnings to reflect that sinking fund requirement in your projections here?

A I don't know where they would specifically come in my projections. If they were allowed for net earnings that I used from the SEC report, they were taken care of.

THE COURT: Why don't we take a short recess.

(Recess.)

BY MR. CASEY:

Q Mr. O'Farrell, I will ask you to turn to page 10 of your report, Defendant's Exhibit C.

Could you explain to the Court the difference between a debt security and an equity security?

A There may be a number of differences, but the prime difference is, the debt security is an obligation that is enforceable under lawand the equity security is a voluntary investment that ordinarily contains rights that are only effective on liquidation of the security.

Q Is the yield on a debt security a matter of corporate discretion to be declared every year, for example?

A No, it is ordinarily included in the indenture.

Q Is the yield on an equity security a matter of corporate discretion?

A It is at the will of the directors if they use reasonable judgment.

Q What point in time does a dividend on an equity security become an enforceable obligation, do you know?

A The yield on an equity security can be enforced by the stockholders if they in a majority express their will to directors, through the directors. Ordinarily, if the directors do not act, the stockholders have to go to court, generally, with a stockholders derivative action.

Q And the yield on a debt security would be characterized as interest?

A On a debt security, yes.

Q The yield on an equity security would be classified as a dividend?

A Yes.

Q Are the preferred and preference shares here involved equity securities?

A They are labeled equity securities, although they don't have the characteristics of common stock which are the true equity securities.

Q Do they have characteristics of debt?

A More characteristics of debt than they have of common stock.

Q Does the debt security generally carry voting rights with it?

A Debt security? No. The preferred stock generally doesn't carry voting rights.

Q Did these preferred and prefrence shares?

A They did have voting rights.

Q For your purposes, did you regard the preferred and preference shares as equity securities in your analysis?

A That is the general classification for them and I followed that if I had to classify them as equity or debt.

Q Can you tell us what cash flow is, if you know?

A That is ordinarily the amount of money that is left in the corporate treasury at the end of the year or accounting amount at the end of the year that did not have to be paid out that year which resulted from operations during the year.

Q Interest would be a fixed charge against that cash flow; is that correct?

A Interest is usually taken before the cash flow is calculated.

Q The sinking fund requirement, is that also a charge against the earnings or the revenues of the company before the cash flow is determined?

A I don't know whether -- in accounting conventions, the sinking fund is a provision for capital retirement and it is normally not considered an expense of the company, I believe.

Q Looking to the paragraph at the top of page 10, could you tell us how you derived the value of $137,706,950, reflected on the second line from the bottom of that paragraph?

A You want me to read it?

Q No, just tell us how you derived it.

A The value to the Cities Service of removing the dividend arrears and the preferred and preference stock, is the value that is being looked for and as explained previously, the value to Cities Service is, to me, obviously, the value to the common stockholders.

The value to the common stockholders will arise through them being able to participate in the profits of the company and to participate in the profits of the company, the first thing that has to be done, they have to remove the barrier of the arrears and the arrears were stated, which probably were correct, at $49,671,950.

The first step in the common stockholders having access to the earnings of the company would be to remove the arrears and they were worth their stated amount as far as their removal and that would be 49 million some thousand.

That left them with an obligation if they were going to pay common stock dividends, an obligation of $3,500,000 some-odd a year of preferred dividends that had to be paid before the common stock could participate in the earnings. At that particular time, the going rate of yield on preferred stock was about 3-3/4 per cent. I used a little higher figure, allowing some cushion, of 4 per cent.

So, this $3,500,000 some-odd that they had to pay out before they could pay dividends to the common stockholders, represented in the marketplace what it cost a corporation to have $88 million in capital on a yield basis of 4 per cent which is obtained by dividing the 4 into the 3,500,000 some-odd. To get to the dividend paying for the common, the company had to remove the arrears and had to support what was equivalent in the marketplace there of a capital charge of $88 million and adding the 49 million-plus for the arrears and the 88 million-plus for the capital charge they were carrying, you have a total of 137 million.

Q When you talk about the capital charge they were carrying, are you referring to the dividends paid out on preferred and preference shares during this period?

A What they represented in capital in the market at that time.

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Q Now, I take it, Mr. O'Farrell, that if the measure, the 4 per cent that you derived from your attachment No. 1, had gone down to say 2 per cent, that this would have had an enormous impact on the value of the stated value of the preferred, is that right? It would have been worth three times as much.

A Not the stated value. But what they represented to Cities Service at that time. Cities Service is interested in dividends in that they represent to them a payment for capital.

Q Sure.

A If they had to pay a three and a half million dollar dividend that represented to them in that market place a payment of 88 million dollars worth of capital

Q Therefore, as I said earlier, if the other preferreds had fallen to an average rate of 2 per cent, the value to Cities Service common shareholders of the existing preferred and preference shares would be three times as much as its stated value, isn't that right, under your approach?

A It would represent that much capital at that time.

Q Yes. So that also the more dividends that were passed and accumulated, the more valuable the

preferred stock was, isn't that correct?

A Not the more valuable the preferred stock was, the more the Cities Service had to pay to cover the earnings for the common.

Q So the more value to Cities Service then, is that correct?

A It would have been more value to it then because it would represent, if you removed it, you were removing more than you were removing at an earlier date.

Q So that the stated yield is what you used, is that correct, in reaching this valuation?

A The obligation they had to pay before they could pay common dividend.

Q What was the actual yield on the preferred and preference shares?

A Actual yield on it? Up to that date, since 1932, with the exception of part of 1941 I believe, the yield had been zero.

Q So that not having to pay out anything, actually, you could support almost an infinity of value?

A Yes, if people gave you your money free, it didn't cost you anything, your capital would be quite voluminous.

Q So it is really a shame that in issuing this

preferred and preference shares, that they didn't have a stated yield of 50 per cent, because when they called it in, they would have had a lot more intrinsic value to the company, isn't that correct, in your approach?

A I don't quite follow that.

Q Well, they weren't paying anything out in any event, but the accumulation of dividends which had passed and were not paid, represented value dollar for dollar, so the more you could stack up there, the more value Cities Service would realize when it issued these debentures, isn't that correct, under your approach?

A No, I don't think that's my approach at all.

Q Well, your approach is they had 49 million dollars worth of accumulated arrearages, and therefore in determining the value to Cities Service common shareholders and therefore to Cities Service, in your opinion, that it contributed 49 million dollars of the 137 million dollars you derived on page 10, isn't that correct?

A The valuation as to the figure for Cities Service, what value it was to them to remove these barriers.

At that particular time the removal of the barriers consisted of the removal of the arrears which its face amount was 49 million. Also, the removal of the necessity of paying out three million and a half

dollars a year. The preferred stock was just paper to them unless they had to pay something on it. To pay dividend on the common they had to pay something on the preferred and preference, and that something was three and a half million dollars a year.

Q Now, if Cities Service in 1947 discovered a new oil field which had a present value in 1947 of, say, 400 million dollars, would you expect the announcement of that discovery to have an effect on the price of the Cities Service common stock?

A If they weren't paying any dividend, it wouldn't have near as much effect on it as it would if they had been paying dividends in my opinion, because the stockholders were at this particular time conditioned to not receiving dividends, so their responses probably wouldn't have been as great as if they were in a normal corporate situation where great increases in the prosperity of the company go down to the stockholders.

Q How much would you expect them to -- how much would you expect the stock market price of the common stock to appreciate with an announcement of a 400 million dollar discovery?

A I couldn't even guess.

MR. WILSON: I object to the question.

THE COURT: Do you want the witness to guess?

MR. CASEY: No, sir, but I would like the witness to answer.

THE COURT: Go ahead.

A I could hardly guess at it.

Q But it would have some?

A I would say every favorable announcement has some response to the common stock.

Q And the 400 million dollars would have a significant impact on the price of the common stock?

A In that situation then I don't know what the effect would be.

Q Supposing that there was an oil field with a present value of 400 million dollars which Cities Service could purchase for a consideration of 115 million dollars, would you expect them to make that purchase, Cities Service or any hypothetical company?

A If they were in the business and had the means, I would say that it would be a bargain purchase.

Q Now, would that kind of a bargain purchase increase the stock market price of the common stock in your opinion?

A If it were publicized, I would say it would have some favorable effect on it.

Q Now, who controlled Cities Service, which group of stockholders controlled Cities Service Company?

A I never could identify any block or group of stockholders.

Q I should rephrase the question.

In your opinion, did the common shareholders control Cities Service Company?

A In total, I assume they did, like they do in all corporations, through their vote for the directors, but there is no certainty in my mind that that was an expression of anything more than lassitude of indifference because of the fact that it was held in very small holdings and no particular individual or group could express his own wishes through his vote.

Q But the common shareholders controlled Cities Service Company, is that correct? They have the voting control in Cities Service.

A Ultimately they had the control, and --

Q I would invite your attention --

MR. WILSON: Your Honor, I object. Again, the witness has not finished his answer.

Q I am sorry, I don't mean to interrupt you.

THE COURT: I think he said the common stockholders had actual control, they had more c

votes than anybody else.

MR. WILSON: Without putting any words in the witness' mouth, I think there may have been more to the witness' answer.

Q Was your answer complete?

THE COURT: I don't see the relevance anyway, but I may be a little thick on the thing.

Q Had you finished your answer to the previous question?

A I don't know now what -- I don't know of any other answer than the common stockholder did control it.

Q Could I invite your attention to attachment No. 8 of your report, Defendant's Exhibit C.

Could you tell us what the line "Net Income" means in this report, in this attachment?

A That was net income after taxes, I believe.

Q What?

A Net income after taxes.

Q And was it also after fixed charges?

A Yes, sir.

Q So this, in effect, was the net income available to the common shareholders, is that correct?

A The top line.

Q Right.

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Now, applying your 50 per cent payoff rate, and your capitalization rate at 5 per cent, could you tell us what the value to Cities Service of the 40 million dollars net income represented? How much?

A About 400 million dollars.

Q 400 million dollars. So that on the actual figures for 1947, using your own analysis and approach to valuation, you would put a value of 400 million dollars to the company in eliminating the preferred and preference shares, is that correct?

A That is using only the 1947. The figure I used was a figure that was taken as a projection of the future, far into the future, not just '47. I used the '47 figure, but the valuation of the common stock does not rest on one year's earnings.

Q But you did use the projected 1947 figure, correct?

A Yes, I used that. I projected the one that was used by the SEC.

Q And the actual 1947 figure was 40 million dollars net income, which yields a value to Cities Service Company of 400 million dollars in eliminating the preferred and preference shares, is that correct?

A On the basis of that one figure and the capitaliza-

tion of the yield that could be obtained from that earning, it would have been 400 million dollars.

Q Now, continuing to look at attachment No. 8, and again at the net income, top line, could you characterize for us the earnings performance of Cities Service Company from 1941 through 1944 in the sense, was it improving, or going downhill, was there any noticeable trend?

A It improved somewhat on the net income basis.

Q Now, the improvement between 1945 and 1944 was what percentage?

A On the net income, the first line?

Q Yes, sir.

A It was about nine and a half million dollars on $17,800,000. It would have been better than 50 per cent.

Q Yesterday you had some reservation about using 1945, so we will skip that, and I will ask you to compare the percentage increase of net income from 1946 to 1947.

A That was a little less than 50 per cent, somewhere in the forties.

Q And the percentage increase then from 1944 to 1947 was what?

A Roughly 140 per cent.

Q So that over a three year period the net income

of the company rose 140 per cent, is that your testimony?

A Well, roughly. I didn't say exactly.

Q Yes, I understand. Roughly 140.

Q Would you expect the common stock prices to reflect this kind of growth in earnings between '44 and '47?

A No, sir.

Q No, sir?

A No, sir.

Q So that earnings have no bearing on the common stock?

A They have bearing but they were not as significant as they would ordinarily be because of the nondividend paying practice and policy of Cities Service at that time.

Q I want to be sure I understand you. Are you saying it had no bearing or that it had a lesser bearing than it would have had if the dividend policy --

A I think it would have had a lesser bearing.

Q But it would have had a bearing?

A I think any increase in earnings ordinarily effects the common stock market prices.

Q Are there other companies, for example, International Business Machine, which has a relatively low yield but high value in your judgment?

MR. WILSON: Your Honor, could we just have a date fixed on the question?

Q Well --

THE COURT: In 1947?

Q Well, in 1947, did you know of any companies which enjoyed high stock market prices at relatively low yields?

A I can't mention any, but I assume there were some.

Q Now, this 400 million dollar asset that you derived from looking at the 1947 net income, that is a corporate asset, I take it? Is that a corporate asset?

A A corporate what?

Q Asset, the value, the asset represented by 400 million dollar value in eliminating the preferred and preference stock, is that a Cities Service Company asset, or is it a common stockholder's asset?

A You have asked me. I answered the question. If you took 40 million dollars after taxes and capitalized that on the basis I did, at a 5 per cent yield, what would it amount to?

I said it would amount to 400 hundred million dollars. I haven't attached that to anything.

Now, I don't understand from your question what attachment you are making to that?

Q Well, in going back to page 10 and taking the 50 per cent payout and capitalizing it at 5 per cent, using the projected earnings, you had no problem in fixing a value of $88,035,000, is that right?

A I have taken your hypothetical question and I have applied a 5 per cent yield, capitalization, to 40 million dollars, reduced by 50 per cent, and I arrived mathematically at a 400 million dollars which is not part of my valuation at all, of course.

Q Well, I suggest to you you derived your value of $137,706,950 by taking 50 per cent of the projected earnings for 1947, representing the payout, and capitalizing that at 5 per cent, isn't that what you did?

A I did that. That was the valuation indication, yes, sir.

Q Now, I am saying that if you substitute the actual figures for 1947 from your own report, attachment No. 8, and did the same thing, treating that net income as after taxes, you derive a 400 million dollar value, and you agree to that, is that correct?

A I don't agree that I arrived at any 400 million dollar value. I agree that I would obtain a 400 million

dollar figure if I worked through the problem that you have propounded. But it has no relation to the value that I have estimated for the preferred and preference stocks to Cities Service at that particular time.

Q My difficulty here, Mr. O'Farrell, is that as you testified you took what the company projected its 1947 earnings would be, correct, and you took 50 per cent of that projected earnings because 50 per cent was,in your opinion, the appropriate payoff level and you capitalized it at 5 per cent, correct?

A I took the figures from the SEC report which I interpreted as being the company's projection of the earnings before taxes for the year 1947.

Q And you --

A They were used in a table that was presented by the SEC which I had related to a table that the SEC had given in their report for the year ending October 31, 1946, and in that tabulation, their before tax figure was 27 million dollars, and I used this table here, using the figure of 29 million and a half for the pro forma, 24 and a half million for the pro forma adjusted, on the basis that that was the figure that was projected for before tax earnings, which corresponded very closely with the pro forma adjusted given in a later

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table in the book for the year ending October 31, 1946.

This pro forma figure in the pro forma adjusted figure were given in the next line after fixed charges, which is the normal way in which earnings before taxes are presented.

And using that figure as is, I said and explained very carefully, a very conservative figure, I projected it -- not projected it, I used it as a very conservative estimate of future earnings before taxes, reduced it by 50 per cent to obtain earnings after taxes, reduced it by 50 per cent on the basis of a 50 per cent pay-out, and arrived at $6,750,000 as the anticipated yield for the common stock projected into the future.

I capitalized that at the going yield rate as reported by Standard and Poor's as an average of 5 per cent and obtained a 135 million dollar figure as what it was worth for the common stockholders of Cities Service to be able to remove the preferred and preference stock and the arrearage and get a reasonable return on their investment.

Q And you are saying that the substitution of actual 1947 figures for the projected 1947 figures and the application of a tax rate that was not pertinent

15 merf O'Farrell - cross

to 1947, that the substitution of the actual numbers does not yield the value to Cities Service Company of eliminating the preferred and preference shares?

A You are giving too much emphasis to the actual and the projected earnings as the sole basis of using the 27 million dollars in the estimate. I concluded that that was a good figure to use because it was presented by the SEC, but it was very much in keeping with the actual that they had reported in their report for the year ending October 31, 1946.

Q Right. And you say at the bottom of page 10 of your report in the double asterisk that "Reasonable accurate estimate for 1947 would have been possible at May 27, 1947," so you used the actual 1947 income before taxes and fixed charges, isn't that correct?

A That has no bearing on my estimate. Just because the action -- if I had known surely what the actual was, it wouldn't have necessarily been my projection for the future. This actual figure was apparently considered by Cities Service very unusual, because they only paid out five million and something dividends in that year. They didn't pay out quite as much as I had anticipated, the $6,750,000, because I was projecting beyond 1947. In 1947 the dividend they paid was between 5 and 6 million.

The next year they went up to 10 million and something.

But in that year there they themselves apparently must have thought the 40 million dollars was unusual because they only paid out about one-eighth of that in dividends.

Q Now, this value that you derived of 137 million dollars, is that in your opinion an asset of Cities Service Company or is it an asset of the common stockholders of Cities Service Company?

A I don't know how the word "asset" comes into this.

Q Is it a value pertinent? You said it was worth to Cities Service 137 million dollars to get rid of this preferred and preference shares. If it is worth 137 million there is a value attached to it, isn't that correct?

A That's right. Worth or value. I will agree on the interchange of the words "worth" and "value."

Q Well, is that "value" attributable to Cities Service Company or is that "value" attributable to the common stockholders of Cities Service Company?

A It was a value for the common stockholders who were, as far as I was concerned, ultimately Cities Service.

Q Thank you. I believe you testified on direct,

Mr. O'Farrell, that frequently, or in the course of your work, you appraise operating companies, is that correct?

A Yes, sir.

Q And in appraising operating companies, do you do anything more than aggregate the value of the physical assets of the company?

A Generally.

Q What else do you do?

A We project their earnings and make a study of their future prospects and the industry in which they are located, their competition, and if you can do so, an appraisal of the management of the company, the environment in which they operate, the age and the effectiveness of the assets that they are using.

A great number of factors are taken into consideration.

Q I would ask you to consider two hypothetical companies, both of them with physical assets of equal value and investment by shareholders of equal value, just to illustrate this point.

If Company A earns $5 a share and pays out $1 a share, and Company B earns $4 a share and pays out $2 a share, which company, which stock has the better yield in your opinion?

A The one that pays out $2 a share, a higher yield.

Q Now, in your opinion which company has greater value?

A It would depend on the industry.

Q Assume the same industry.

A The same industry?

Q They are identical in all respects except for the earnings and payout, the dividend policy.

A I can't answer it categorically because in certain industries you can by analysis of past pricing of the stocks get a pretty good indication that the dividend has been a detriment in stock pricing rather than an advantage in stock pricing.

In other words, that where they paid out dividends it was a negative factor in determining market price of the stock, because some of the investors or at least enough of them to effect the market pricing, had the view that in certain growth industries it is detrimental to the company to pay out dividends as long as they are growing, so they consider a dividend payment a balck mark against them.

MR. CASEY: Could we have just a minute, your Honor?

THE COURT: Of course.

(Pause.)

MR. CASEY: Thank you, Mr. O'Farrell, I have no further questions.

MR.WILSON: No further questions.

THE COURT: You are excused. Thank you.

(Witness excused.)

MR. MURPHY: Your Honor, the next witness the Government puts forward is put forward by deposition, which is Mr. Chandler. His deposition is Defendant's Exhibit E which is in evidence already in this court. It is available for your Honor to read at his leisure. However, as part of the transcript, the actual transcript put in at this time, unless it could be assumed that the whole transcript has been read in, the Government would propose to read in various portions on which it would like to place principal reliance.

THE COURT: Whatever you want to do. It is an exhibit. You can also read whatever parts of it and plaintiffs can read whatever part they want.

MR. TYRE: I would suggest the whole thing be submitted if it is going to be submitted at all.

THE COURT: Read the whole thing or just make it part of the record.

MR. MURPHY: This is Defendant's Exhibit E. It is 50 pages.

THE COURT: What is your pleasure?

MR. TYRE: I have an objection to the admission of the exhibit in the first place but that has already been acted upon and subject to that reservation, if it goes in at all, I would like the whole thing to go in.

ks2

THE COURT: It is in. It is just a question of if it was read.

MR. TYRE: I wouldn't care to have it read.

THE COURT: Only certain portions would be read that the Government wanted to stress and possibly there would be parts that the plaintiff wanted read that they thought was favorable to them.

I am just trying to think of being able to close the day.

Whatever you want to do is perfectly all right with me.

MR. MURPHY: The purpose, your Honor, the Government would propose to argue from certain remarks made in that deposition at the closing arguments of the case, hopefully today.

THE COURT: How much of it do you want to read?

MR. MURPHY: I think the Government would propose to read about ten pages all together.

THE COURT: Then if plaintiff wants to read a portion of it --

MR. TYRE: I think it is necessary for us to put the whole thing in the record because we have objected continuously all along in the deposition.

THE COURT: It is all in the record. It is just

a question of what portions are read, what portions are not read but which are available as part of the record.

Why don't you go ahead.

MR. MURPHY: Your Honor, I will hand up to the Court Exhibit E and we will read from a Xerox copy.

We note, your Honor, the original of this deposition has been filed in the court by letter that we have from the Northern District of Illinois dated July 5, 1972. It should be on file some place with the other papers in the case.

Beginning at page 2 at the bottom on direct examination by myself.

"Q May I have your name, please?

"A Marvin Chandler.

"Q And your address?

"A Business?

"Q Yes, sir.

"A Post Office Box 190, Aurora, Illinois, 60507.

"Q Are you appearing here pursuant to a subpoena, sir?

"A Yes."

Turning to page 4 in the middle of that page.

"Q Mr. Chandler, are you willing to testify voluntarily as a paid witness for the United States in

the proceedings Cities Service Company against the United States?

"A No.

"Q Why not, sir?

"A Well, regardless of my own personal desire to do so or not to do so, I decided it would be inappropriate as an officer of the Northern Illinois Gas Company, because of our potential business relationships with the Cities Service Company. We are a seeker of gas supplies in a period of gas shortage and liquid hydrocarbon feed stocks for the manufacture of gas. Cities Service is an explorer and producer of those commodities and we have had discussions with them in the past and I didn't want to take any stand that might impair the present relationships of Northern Illinois Gas Company.

"Q Do you have any other reason besides that one given as to why you might not be willing to testify voluntarily for the Government in this proceeding?

"A Well, that relationship I speak of goes both to the corporate propriety, one might say, and also to my own personal situation as a holder of some share units of Northern Illinois Gas stock, which are equivalent for dividend purposes to shares of stock and the continuance of the income from those units, or the possession of those

units is contingent on not doing anything that would be harmful to the corporation. So, of my own sense of concern with both one of corporate propriety and personal interest, I want to do the right thing by Northern Illinois Gas Company and I want to do the right thing by Marvin Chandler.

"Q Are you presently employed, sir?

"A Yes.

"Q Who is your employer?

"A Northern Illinois Gas Company.

"Q Do you have a position with that company?

"A Yes, chairman of the executive committee.

"Q How long have you held that position?

"A Since last June, a year ago.

"Q Did you have a position with Northern Illinois Gas Company before you were chairman of the executive committee?

"A Yes.

"Q What was that position?

"A Chairman and chief executive officer.

"Q How long were you chairman and chief executive officer of Northern Illinois Gas Company?

"A Well, I think it might simplify it because the dates are not precise in my mind to say that I became

president in November of 1954. Became chief executive officer in addition to the presidency title in June of 1955 and subsequently became chairman and president and subsequent to that chairman, but I was chief executive officer from 1955 to June of 1971. The title changing somewhat over a period."

THE COURT: This is what you want to stress in your argument?

MR. MURPHY: This is qualifications, your Honor.

THE COURT: I can read the qualifications.

MR. MURPHY: Just one thing.

"A It is a major distributor of natural gas over a territory in Northern Illinois. It is about the sixth largest distributor of natural gas in the United States. We do about $400 million worth of business a year."

THE COURT: I am going to read the entire thing.

MR. MURPHY: Your Honor, I would just like to go on to page 26 and 27, after identifying the plan submitted to the SEC by Cities Service and the amended plan.

We will go back into the quoted portion of

the Q and A.

"Q Was the firm of Reis & Chandler, Inc. employed with respect to Exhibits D and G," which should read C and F, "and those are the both plans?

"A Yes.

"Q When were they so employed?

"A It was along in January 1947.

"Q By whom were they so employed?

"A By the protective committee for the preferred stockholders of Cities Service.

"Q What was the nature of the employment of Reis & Chandler?

"A Well, we were asked to examine the first plan, to see whether we thought it treated the preferred stockholders fairly and equitably and prepared testimony with respect to our conclusions to be given by the Securities & Exchange Commission, when it considered the plan.

"Q Did you yourself work on that project for Reis & Chandler?

"A Yes.

"Q And what did you do with respect to that project?

"A I looked primarily at the preferred stock, as

to what the shareholders had and were giving up, what the value of the preferred shares was at that time.

"Q Did you reach an opinion in 1947 on whether the preferred and preference stocks dividend arrear could and should have been paid in cash by Cities Service Coppany?

"A Yes.

"Q What was that opinion?

"A I concluded that they could have been and should have been paid in cash.

"Q What were the facts on which you based that opinion?

"A I studied the cash which seemed to be adequate, and working capital seemed to be adequate. It didn't seem to unduly impair or impede the Cities Service to pay the arrears."

Then continuing on --

MR. TYRE: Your Honor, should I interrupt when I want additional material in the record or should I ask him to continue reading?

THE COURT: I don't care.

MR. TYRE: I would ask you to continue reading.

MR. MURPHY: Continuing on to 33 and 34, your Honor, still examination by myself.

"Q Do you remember, Mr. Chandler, independent of United States Exhibit 1 for identification, whether you reached an opinion as to the value in 1947 of the preferred and preference stocks?

"A Yes.

"Q Did you reach an opinion?

"A Yes.

"Q And do you remember that independent of this exhibit which is in evidence?

"A Yes.

"Q What is that opinion, sir?

"A I reached the conclusion that the arrears could and should have been paid and that the investment value of the preferred and preference issues or the arrears paid and regular dividends paid, it would be in excess of call price."

Skipping two lines, your Honor.

"Q What were the facts on which you based that opinion?

"A Well, I studied the situation of Cities Service, its financial statements, the coverage of preferred dividends by any income which was and would be available and I made some comparisons with other preferreds, with ready markets, to see where they were selling on a yield

basis and concluded that on a yield basis that dividend rates on the Cities Service issues would carry them to a price moderately above the call prices."

Skipping, your Honor.

"Q What were the reasons that you had which supported the opinion you reached back in 1947?

"A Well, the opinion was supported by the studies I made, which are shown in Exhibit 1 and they related as I indicated, to dividend coverage on a corporate and consolidated basis, and financial ratios, various financial ratios such as the capitalization ratio, comparison of similar statistics on other companies, the market prices of other companies preferred, was selling at, yield on preferreds in general at that time; a raft of factors which a financial analyst would look at to reach an investment value decision."

Then skipping to page 37, your Honor, there is a typo in this question and I will read it to correct the typo as it appears.

THE COURT: What page?

MR. MURPHY: Page 37, the last date should be May 27, 1947, not 27, 1927. I will read it correct.

"Q Now, Mr. Chandler, I ask you do you have an opinion of the value to Cities Service Company of their

preferred and preference stocks and the dividend arrearages on them, received by Cities Service Company on May 27, 1947?

"A Yes.

"Q And what is that opinion, sir?

"A I think Cities Service got a good buy, a good bargain in getting the preferreds discharged at less than call price plus arrears."

The Government has nothing further to read.

MR. TYRE: If your Honor please, with regard to this SEC transcript, and exhibit of Reis & Chandler that was submitted, I have excerpts from the SEC hearings transcript that deal with the submission of that exhibit into the record at the SEC.

With your Honor's permission, I would like to submit that portion of the hearings record into evidence in this case as a plaintiff's exhibit.

I realize it is somewhat unusual but I am caught off base slightly by the fact that the defendant wants to read all this SEC business into the record.

However, I do have the complete transcript available and I will put that in the record.

THE COURT: This was a deposition taken in this very action. I don't know what SEC business we are

talking about.

MR. TYRE: The exhibit attached to Mr. Chandler's deposition is an SEC exhibit and this transcript of the hearings at the SEC explains why it was submitted to the SEC and it has to do with that entire exhibit.

THE COURT: We can receive it on the question of your objection to its receipt in evidence which I have already ruled on.

MR. MURPHY: No objection, your Honor.

(Plaintiff's Exhibit 7 was received in evidence.)

xx THE COURT: Instead of calling another witness, we might as well adjourn to 2 o'clock.

MR. MURPHY: We have only one more witness, the Government then will close.

(Luncheon recess.)

1-1 merf pm

AFTERNOON SESSION

2:00 p.m.

MR. MURPHY: May it please the Court, your Honor, the Government calls Mr. Goulston.

L E O G O U L S T O N, a witness, being first duly sworn, was examined and testified as follows:

DIRECT EXAMINATION

BY MR. MURPHY:

Q May I have your address?

A 1201 South Scott Street, Arlington, Virginia.

Q Are you employed, sir?

A Yes, sir.

Q Who is your employer?

A Internal Revenue Service.

Q Are you assigned to any particular section within the Internal Revenue Service?

A Valuation and Analysis Section.

Q What are your duties in the Valuation and Analysis Section?

A I am a financial analyst. I do research and analysis on stock valuations, write reports, assist attorneys and testify, if necessary.

Q How long have you been in the Valuation and

Analysis Section of the Internal Revenue Service?

A Since July 1964.

Q Would you give the Court your background and experience before you joined the Valuation and Analysis Section of Internal Revenue Service?

A I attended the College of Business Administration School of Law of Boston University. I attended evening college at Boston University, I worked from 1938 to 1946 for Bache & Co. as an analyst and I wrote field reports, visited New England corporations and wrote reports for the home office.

From 1947 through '50 I worked for Hagden, Stone as an analyst, and from 1951 to 1957, I was vice-president of a manufacturing corporation, 1958 I was manager of Levitt-Spooner which is a branch office of Hentz & Co. of New York, and from 1959 to 1963 I was investment counselor with Standard and Poor's and from 1964 to the present I am a financial analyst with Internal Revenue Service.

Q Did you receive a degree from your college?

A Yes,I did, LLB from Boston University.

Q Bachelor of Laws?

A Bachelor of Laws.

Q Have you practiced law?

A No, sir.

Q Have you ever testified before in your status as valuation analyst for the Internal Revenue Service?

A Yes, I have.

Q How many times?

A About ten times.

Q In what courts have you testified?

A Court of Claims and the Tax Court generally.

Q Are you familiar with Judge Mansfield's opinion handed down in this case?

A I read it, yes.

Q In the course of your duties for the Valuation and Analysis Section were you asked to look into the exchange by Cities Service Company of preferred and preference stocks for 3 per cent debentures which exchange occurred on May 27th and 28th, 1947?

A Yes, I was.

Q Were you asked to determine whether there was any loss to Cities Service on that exchange?

A Yes, I was.

Q And did you make such a determination?

A Yes, I did.

Q Did you reduce your determination to writing?

A Yes, I did.

Q I show you Defendant's Exhibit S, which is

already in evidence, and ask you if this is that writing?

A Yes, it is.

THE COURT: Do you have a copy of that exhibit?

(Document handed to Court.)

Q And did you come to an opinion, sir?

A Yes, I did.

Q And what was your opinion?

A That Cities Service did not suffer any loss by this exchange of the 3 per cent debentures in 1947 for the elimination of the preferred and preference stocks with accumulated dividends.

Q And what was the basis for that opinion?

A Cities Service Company and subsidiaries, showed an increase in consolidated gross operating revenues from 238 million in 1940 to 333 million in 1946. The net income increased from approximately 10 million dollars in 1940 to 27 million dollars in 1946. The overall charges and preferred dividends requirements earned increase from 1.19 in 1940 to 2.08 in 1946.

The $6 preferred dividends earned increase from 2.94 times in 1940 to 8.10 times in 1945. The consolidated surplus, all sources, the net, increased from $20,496,000 in 1940 to 131 million dollars in 1946.

With an increase of over 500 per cent in

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consolidated surplus of Cities Service in six years, from over 20 million dollars in 1940, to over 131 million dollars in 1946, it is reasonable to assume that within a short time, probably five years, dividends on accumulated preferred would have to be paid. With the continued growth in earnings and improvement in its financial condition, Cities Service probably would be compelled to clear up their accumulated arrearages within ten years at the latest in my opinion. It would depend upon the operations of the company and how long the preferred shareholders would withhold legal action.

It is my opinion that the accumulated dividends on the preferred shares would definitely be cleared up long before the maturity date of the 3 per cent debentures of 1977.

By paying for these arrearages with a low coupon 3 per cent debenture, Cities Service did escape from paying the full amount of the preferred and arrearages at some future date when the payment would have been at least the face amount of the debentures issued in 1947.

Cities Service merely swapped a 30 year promise to pay for a future promise contingent upon the order of the Court.

Cities Service's exchange of debenture with

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a tax deductible interest for a future liability of stated value over the preferred plus accumulated dividends which are payable out of after tax income. In my opinion Cities Service did not suffer any loss by this exchange.

Q And did you write that opinion, sir?

A Yes, I wrote that.

Q Was it typed in the Internal Revenue Service offices?

A It was typed in the clerical pool at the U. S. Attorney's office, I believe.

MR. MURPHY: No further questions.

Your witness.

CROSS-EXAMINATION

BY MR. TYRE:

Q Mr. Goulston, my name is Tyre and I am representing Cities Service in this case.

A How do you do.

Q I just have a couple of questions I'd like to ask you about your analysis.

I understand that you are an employee of the Internal Revenue Service in Washington, D.C.

A Yes, sir.

Q How long have you been employed there in Washington?

A From July 1964.

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Q When were you assigned to work on this case or the issue that you --

A January 1972.

Q In January of 1972?

A Yes, sir.

Q When was your analysis that was submitted as Exhibit S in this case typed?

A I believe Friday, this last Friday.

Q Prior to last Friday, had you reduced any of your work to writing?

A Yes, I had some memos.

Q Do you work with Mr. O'Farrell, the previous witness in this case for the defendant?

A Yes, I do.

Q Are you in the same section?

A Not exactly. He's in a little different section.

Q Is Mr. Taylor your reviewer?

A Yes, he is.

No, he is not my reviewer, he is the chief of the section. My reviewer is Dwight Williams. Mr. Taylor is in charge of the section.

Q You work in the same section but you have a different reviewer?

MR. MURPHY: Objection, your Honor.

A No, we work in different sections, I said.

Q You and Mr. O'Farrell work in different sections?

A Well, different sections of the Valuation and Analysis Section. I have reviewer, Dwight Williams. He is in the real estate and securities, and another section there.

Q A different subsection?

A Different subsections, right.

Q Did your reviewer review this?

A No, he didn't.

Q This analysis?

MR. MURPHY: The answer.

THE COURT: No, he didn't, he said.

A No.

Q Is that a divergence from the rule?

A Not exactly.

Q The Internal Revenue Service rules?

A No, we make independent opinions. I discussed this with Dwight Williams before I came up here but I had a draft on it. He doesn't have to review every case.

Q Isn't the nature of your duties with the Internal Revenue Service to render opinions that support the position

the Government intends to take in a case?

A That's entirely incorrect.

Q Do you know what the Government's position is in this case?

A Yes, I do.

Q Could you state it in your own words?

A That Cities Service Company received no loss upon the exchange of their debentures for the preferred stock.

Q Could you estimate for the record approximately how much time was required by you to prepare your analysis that is submitted in this case as Defendant's Exhibit S?

A I have spent over 100 hours on the case, and I probably spent on this analysis about four days, probably.

Q You stated that you are and were aware of the Government's position in this case.

Where did you get that information?

A Well, I read Judge Mansfield's opinion, what was the issue here, and I discussed this case with our office and a lot of other people and so forth.

I discussed it also with experts and I have a fair idea of what the Government's position is. I am not a legal expert.

Q But you got it primarily from Judge Mansfield's opinion, would you say?

A General discussion.

Q Discussion?

A Yes.

Q Of Judge Mansfield's opinion or a reading.

A No, no, no, from general discussion in our office.

Q Excuse me, I misunderstood.

Now, in addition to the matters and materials cited in your analysis, did you take into consideration any other material in arriving at your analysis and conclusion?

A I took into consideration the general market conditions at the time, the advantages to Cities Service.

Q But you didn't see fit to include any of that material in your report?

A I didn't think it was necessary.

Q Did you consult any sources of information?

A Yes. Standard and Poor's, Moody's, I read books on dividends.

Q Were you aware at any time that interrogatories had been filed in this case asking the parties to disclose the identity of their expert witnesses?

A I have a vague idea that it was done but I am not sure that I was completely aware of when and what they did.

Q When were you actually told by the defendant that you would be an expert witness in this case?

A I believe it was Wednesday afternoon.

Q Last week?

A Last week.

Q Now, may I direct your attention to your report. I have finished with preliminary inquiry and I'd like to get into the matters contained therein and I suppose you would like to look at it?

A Sure.

Q With reference to your very first sentence where you talk about operating revenue, you use the term "consolidated."

A That's right.

Q Do you mean for the whole system, I take it?

A Yes, sir.

Q Is this consolidated figure that you used after taxes or before taxes?

A Consolidated operating revenues you are talking about?

Q Right. On the next page. You refer to consoli-

dated gross operating revenues on page 1.

A Yes.

Q On page 2 you refer to consolidated surplus. In using those figures have you taken into consideration any tax amounts?

A Are you talking about consolidated surplus?

Q Just those figures. Has any kind of tax payments entered into your computations there?

A No tax.

Q You didn't compute those figures?

A This was after taxes.

Q All right, fine. That's the answer I expected.

A Yes.

Q The very next line in your analysis on page 1, the net income increase, and so forth.

Do you see that sentence?

A Yes, I do.

Q Will you recite the figures contained there?

A The net income increased from 9,928,029 in 1940 to 27,253,121 in 1946.

Q Are these figures before or after taxes?

A After taxes.

Q Beg pardon?

A After taxes.

Q What are the sources of those figures?

A Moody's Industrial Manual.

Q Are those actual earnings or actual net income of the company?

A That is what is stated in Moody's.

Q On page 2 of your analysis, you refer in the very first line to consolidated surplus.

Are dividends paid from consolidated surplus, generally?

A Generally, not. Generally from income.

Q As a general proposition, is the entire consolidated surplus of a holding company and its operating companies available for dividends, would you say?

A Yes, I would think so.

Q Continuing on the same page, the very next paragraph, the last sentence.

Would you read it, please?

A Where it starts "Economic and legal history ..."

Q No, the last sentence in the first complete paragraph on page 2, "They should not be permitted ..." It begins.

A You are talking about page 2?

Q Page 2 of your analysis.

A The last sentence?

Q The first complete paragraph on that page.

A The first paragraph?

Q Yes. The last sentence of the first complete paragraph on that page.

A "It is a general rule that the declaration of dividends is left to the honest judgment of the board of directors of each corporation. The existence of undivided profits gives no right to a dividend. The discretion of directors is not unlimited. It must be honestly exercised for the benefit of the corporation and all shareholders."

Q Excuse me for interrupting, this is the sentence I want to direct your attention to, the one you are going

to read now.

A "They should not be permitted to withhold dividends to favor one class as against another, or to plow back profits indefinitely for ulterior motives."

Q That word "ulterior", is that your word?

A No, that was taken --

Q I beg pardon?

A I believe I copied that from a law text of some kind.

Q A law text?

A Yes.

Q Do you have any idea how one would plow back profits for ulterior motives?

A There must be many ways. A fellow could plow back profits and -- are you talking about a closely held corporation or a big corporation like Cities?

Q That is not my report.

A This is a general statement.

Q It is proffered as your opinion?

A Well, maybe in a small company a fellow could put the profits back and buy a couple of Cadillacs and squander the money on personal things and try to get away with an increase of travel expensee, something like that.

Q The very next sentence in the next paragraph,

please read that?

A "The class of stock involved bears on the degree of proof required."

Q Proof of what?

A Well, I would say if you are talking about preferred stock, it may be a little easier to prove the dividends should be forthcoming than if you are talking about common stock.

MR. TYRE: Would you read that answer.

(Answer read.)

Q Is that the proof you are talking about in this case?

A This is just a general paragraph, general statement in context as to the duties of the directors in declaring dividends. I am not trying to be precise on every legal point in this discussion.

Q Are you indicating here there was some indication that the preferred dividends were withheld to favor the common over the preferred?

A In Cities Service?

Q Yes.

A This is just a general discussion on dividends and duties of directors. I didn't refer in this paragraph to Cities Service.

Q You don't know of any action of any kind that would raise that issue involving Cities Service, any court action?

A No, I don't.

MR. MURPHY: Objection. Can we have the time on that?

Q In 1947 or prior thereto?

A No, I don't know of any action.

Q Will you please read for the record the last sentence in that paragraph?

A "Courts have rejected the argument that the provision for accumulation" --

Q The last sentence in the paragraph "Economic and legal history..."

A "Economic and legal history have shown that, in practice, dividends in arrears all too frequently are wiped out in reorganization or by charter amendments."

Q Will you go back and read the second sentence of that same paragraph?

A "Holders of cumulative preferred stock upon which dividends have been withheld are generally granted relief"; given the proper circumstances, naturally.

Q Do you know how long the dividends on the preferred stock of Cities Service had accumulated?

A Since 1932, I believe. This is a paragraph that does not refer specifically to Cities Service.

Q You refer to charter amendments. Could Cities Service have wiped out its dividend arrears by a charter amendment?

A Not in this case, I don't think.

Q You don't th ink they could? You say they could or somebody could?

A Now you are getting into legal complications here.

Q Can you think of any other ways that Cities Service could have gotten rid of its arrears in preferred dividends?

A Pay cash.

Q Any other way?

A The way they did on exchange.

Q Any other ways?

A I think they could have had a vote of the preferred stockholders to waive it.

Q Could they have purchased the stock in the open market?

A They could have purchased the stock in the open market and accumulated all the preferreds.

Q And they would have paid what, for that preferred

stock?

A It depends on market conditions at the time it was bought.

Q I call your attention to page 3 of your analysis, the last sentence, please.

A "It is the opinion" --

Q The first paragraph on page 3, the last sentence in that paragraph.

A Will you say that again, please?

Q The last sentence in the first paragraph on page 3 of your analysis.

A "The circumstances in each individual situation must ultimately be the basis for determining the issue of good faith."

Q Do you know of any good or bad faith involved in the Cities Service?

A No, I don't.

Q The very next paragraph, on the same page, you say, beginning on the third line, and I will quote so we don't have trouble finding it.

"It is reasonable to assume that within a short time, probably within five years ..."

I direct your attention to that statement.

With that statement in mind, can you tell me

if you read the findings of fact and the opinion of the Securities & Exchange Commission that is attached as Exhibit G to Defendant's Exhibit A in this case?

A I am not sure whether I read that. I read parts of the SEC thing.

Q Are you aware of what the SEC said with regard to the possibility or probability of dividends on the preferred shares?

A I would say no to that.

Q Continuing in the same paragraph, about four lines down from where we left off, you state:

"Cities Service would be compelled to clear up their accumulated arrearages."

A That is right.

Q Would you think about that for a moment?

A Yes.

Q May I ask you, what you mean, or what you had in mind when you used the phrase "clear up"?

A Assuming that Cities Service didn't pay the accumulations on the preferred and given the gross and earnings and the improvement in the financial condition, it is my opinion that within ten years Cities Service would have been compelled to pay the accumulated dividends on the preferred.

Q But you also agree there were other ways that they could have avoided it?

A There are other ways. I am just making the general statement.

Q You make the same reference at the bottom of that page in the last complete sentence to the clearing up of dividends?

A Yes.

Q Isn't there a basic assumption in that statement that Cities Service would have to remain in business long enough to do all that?

A What are you talking about?

Q You are talking about ten years, are you not?

A Yes.

Q You have to assume they are going to stay in business that long?

A Naturally.

Q Now I will direct your attention to page 4 of your analysis, the first line, "Cash or the equivalent ..."

Do you see that phrase?

A Yes, I do.

Q Is it your position in this case or in your testimony that the debentures that were issued are the equivalent of cash?

A For the purposes of clearing up the arrearages, I would say yes.

Q But only for that purpose?

A For these debentures, yes.

Q Will you just silently read through that entire paragraph, I would like to ask you a couple of questions about it, but I don't want to repeat the whole thing for the record.

A Yes, sir.

Q Is it your opinion that what was involved here was an even swap?

A Yes, sir.

Q Is it also your opinion that a firm binding obligation to pay money is the eqivalent of a contingent obligation to pay money?

A No, I didn't say that.

Q You don't say that?

A I don't mean that exactly. I am saying that the debentures are a firm commitment, a firm obligation, but then I previously said within 30 years before the maturity date of the debentures, Cities Service in my opinion would have been compelled to pay the accumulations on the preferred, so they are only issuing a 30-year promise at a low coupon rate at 3 per cent in 1947 for

the accumulations they would pay. They would have to pay them obviously at 30 years at the particular rate of improvement.

Q But you say that is an equal swap?

A In a sense it is a swap.

Q Let me refer you to the last sentence or conclusion on that page and ask you to read it for the record, please, it begins "Cities Service did not ..."

A "Cities Service did not suffer any loss by this exchange of 3 per cent debentures in 1947 for the elimination of the preferred and preference stocks with accumulated dividends."

Q That is your conclusion based on your analysis?

A Yes.

Q Who posed that question to you?

A We had a discussion on that.

Q Somebody told you that was your mission in this case?

A That is incorrect. You have a misconception of that.

Q How did you arrive at that conclusion?

A I had been of the opinion that Cities Service didn't lose anything on this deal. In fact, it was a good deal for them and I have been saying it right along.

Q When you say Cities Service did not suffer any loss, what kind of loss are you talking about?

A They exchanged the 115 million debentures to clear up the call price plus the arrearages and to me that was something they were going to have to do and they did it at the time money rates were the lowest in history and they were very fortunate to be able to make that exchange at that time.

Q You are an employee of the Internal Revenue Service?

A Yes.

Q Were you by any chance referring to a tax loss?

A I don't know much about tax. I am a financial analyst.

Q What kind of a loss other than a tax loss? Are you talking about an economic loss?

A You are talking about a loss in money from the exchange.

Q A financial loss?

A Yes.

Q And nobody told you that was the issue in this case?

A I had an idea that was what they were driving at, value to a plaintiff, whether it was less or more

than the debentures.

Q Tell me now how you put a dollar value on what Cities got for their debentures?

A I didn't put a dollar value. This is an overall exchange and in my opinion they lost nothing by the swap. It was good business for them.

Q Did they have anything? What did they have before they made the swap?

A They exchanged the preferreds for the arrearages -- for the debentures, and that is the swap.

Q Didn't the preferred shareholders have the arrearages?

A Yes.

Q The claim?

A If you want to be technical --

Q Yes, I do.

A The shareholders gave up their preferreds with the accumulated dividends for Cities Service 3 per cent debentures. That was the exchange.

Q You made no attempt to put any dollar value on that?

A No dollar value.

Q You didn't know what preferred claims amounted to in dollars, did you?

A They amounted to the same amount as the debentures.

Q You just totaled up the figures?

A Totaled up the figures.

Q May I ask you a hypothetical question as an expert?

A Sure.

Q Assume that Cities Service issued those debentures, issued the debentures and received in turn $45 in cash and later Cities Service bought the debentures in the open market for $90. Would that have a loss?

MR. MURPHY: Objection, your Honor.

I would ask the attorney if he is asking a tax question, as a tax issue --

MR. TYRE: I really don't care. It is a hypothetical question. He says they experienced a loss and I am giving him some figures. He should be able to tell me in his opinion.

THE COURT: You are dealing with it in the context of his opinion, not a legal question?

MR. TYRE: Precisely.

A You are talking about them going out in the market and buying the debenture at 90? Cities Service would have a gain in buying the debenture at a discount.

Is that what you are talking about?

Q Are you concluding as a matter of your total testimony here that the debentures that were issued by Cities Service were of more utility value to the company than the preferred?

A I would say it would be an equal exchange.

Q Mr. Goulston, isn't this analysis really a legal brief?

A No. My analysis?

Q Yes.

A No.

Q It is not?

A Of course not.

Q I have one minor question with which I hope to finish up.

With reference to your list of qualifications attached to your analysis, may I direct your attention to it?

A Yes.

Q The very last line where it says "References."

A Yes.

Q To whom may I direct my request?

A You could direct your request to the chief of my section.

Q Thank you very much.

MR. TYRE: No further questions.

MR. MURPHY: No further questions.

THE COURT: Thank you, you are excused.

MR. MURPHY: The Government rests, your Honor.

MR. TYRE: Excuse me, may I have one more question.

MR. MURPHY: No objection.

BY MR. TYRE:

Q Mr. Goulston, with reference to your analysis at the first page at the very top, I see the initials DHM. Whose are those initials?

A Daniel H. Murphy.

Q Who is he?

A He is the attorney that had this thing typed for me.

MR. MURPHY: I have one question on redirect.

REDIRECT EXAMINATION

XX BY MR. MURPHY:

Q Mr. Goulston, why are the initials DHM in the upper lefthand corner of your report?

A I went in to you with my draft and I said, "Dan, will you have this typed for me," and for some reason or another you put your initials on the top and

brought it into the clerical pool.

MR. MURPHY: Thank you.

No further questions.

The Government rests.

MR. TYRE: If your Honor please, the plaintiff would move for a judgment on the record. I can be heard in about two minutes on the subject.

THE COURT: I will hear from both sides.

I will hear from the plaintiff first.

I will reserve decision on that after looking at these exhibits and the record.

MR. TYRE: If your Honor please, the issue in this trial between the parties and before the Court is pursuant to an order issued by Judge Mansfield on February 11, 1971 wherein it was stated and I quote:

"It is further ordered and adjudged and decreed that this case be set down for trial in due course with the sole factual question to be resolved thereat, being the value to plaintiff of the preferred and preference shares received by it in exchange for the issuance of its 3 per cent 30-year sinking fund debentures.

"The bonds.

"On May 27, 1947.

"It is further ordered adjudged and decreed that, pursuant to Federal Rules of Civil Procedure 56(d), the bonds shall be deemed issued at a price equal to the value to plaintiff of the preferred and preference shares received in exchange for their issuance on May 27, 1947.

"It is further ordered adjudged and decreed pursuant to Federal Rules of Civil Procedure 56(d), the value of those shares to plaintiff shall be no less than $45,323,846. The value of the consideration origially received for their issuance.

"It is further ordered adjudged and decreed upon resolution of said sole remaining factual issue between the parties, the amount of any deductible loss or discount will be determined by mathematical calculation."

In this case, the plaintiff has introduced evidence which shows in our view conclusively that the entire consideration received by Cities Service for the issuance of its 3 per cent debetures was the $45 million dollars.

It was the maximum consideration and the minimum consideration.

Therefore, by strict mathematical, simple

mathematical computation, the deductible discount or loss can be measured.

I might point out at this time, it is not plaintiff's contention regardless of the assumption by defendant's witnesses that the loss was incurred upon the exchange. It is plaintiff's contention that the loss was experienced when the bonds were ultimately redeemed themselves in the taxable years before the Court.

The defendant has introduced testimony to the effect that the common stockholders of Cities Service received some benefit and he also introduced testimony to the fact that no loss was incurred in 1947, on the date of the exchange.

The plaintiff submits that that evidence does not address itself to the issue in this case and that by the preponderance of the evidence and because it supports its burden of proof, plaintiff is entitled to judgment on this issue.

Thank you.

MR. MURPHY: Your Honor, the Government moves at this time for a judgment of the Court dismissing plaintiff's complaint because of all the evidence. We also ask for time to put in post-trial briefs in this case summarizing our views both on the law --

rks

THE COURT: That applies to both sides.

MR. MURPHY: Your Honor, we have already stated the grounds for our motion as to the plaintiff's case at the close of the plaintiff's case. As far as the defendant's case goes, in sum, the United States has presented perhaps three theories here on the facts which the United States contends each of which is compelling upon the Court to conclude that the difference between the debentures received by Cities Service and the debentures given up by Cities Service and preferred and preference stock received by Cities Service was no loss in this case.

Two of our witnesses, one by deposition and one orally went to the issue that to Cities Service to receive this preferred and preference stock with its outstanding accumulated dividends, the value to Cities Service was more than the $115 million in cash amount of the debentures.

The third witness looks at it from a different viewpoint, different type of factual theory. To them, that witness is somewhat different from that phrase used by Judge Mansfield, and more fundamentally used by Judge Mansfield, which is, what is the difference between that given up and that received by the taxpayer, and look-

rks

ing at it that way on this exchange, Mr. Goulston's opinion is there was no loss or no true loss as Judge Mansfield coined the phrase in his opinion.

THE COURT: I will reserve decision.

MR. TYRE: May we have a briefing schedule, your Honor?

THE COURT: That is what I was about to do.

MR. TYRE: We would like to have simultaneous briefs, if it is possible.

THE COURT: What dates do you suggest?

MR. TYRE: 45 days would be convenient to us.

MR. MURPHY: Your Honor, it is really for your convenience, but sometimes the Court would prefer to have briefs brought in in shorter time so the facts are still fresh in the Court's mind. If the Court is of that turn, 21 days will be fine with the Government otherwise 45 days.

THE COURT: I could keep the facts in my head for 45 days but it is the appl ication of the facts so 45 days is okay and we will say 10 days to respond?

MR. MURPHY: Fine.

MR. TYRE: Yes.

MR. MURPHY: 45 days to exchange briefs and 10 days to respond to opponent's brief at that exchange.

THE COURT: Yes.

(Time noted: 2.50 p.m.)

WITNESS INDEX

NAME	DIRECT	CROSS	REDIRECT	RECROSS
John O'Farrell		291		
"Marvin Chandler	351			
Leo Goulston	361	367	389	

EXHIBIT INDEX

Plaintiff	Identification	Evidence
7		360

July 26, 1972
11:00 o'clock a.m.

UNITED STATES DISTRICT COURT FOR THE
SOUTHERN DISTRICT OF NEW YORK

UNITED SERVICE COMPANY,

Plaintiff,

vs.

UNITED STATES OF AMERICA,

Defendant.

67 CIV. 4606 CHT

D E P O S I T I O N
of
MARVIN CHANDLER

UNITED STATES DISTRICT COURT FOR THE
SOUTHERN DISTRICT OF NEW YORK

[illegible] SERVICE COMPANY, Plaintiff, vs. UNITED STATES OF AMERICA, Defendant.	67 CIV. 4506 CHT

The deposition of HARVIN CHANDLER, called by the defendant for examination, pursuant to subpoena, and pursuant to the Rules of Civil Procedure for the District Courts of the United States, taken before Jeanette Hansen, a notary public within and for the County of Cook and State of Illinois, at the Federal Building, U.S. Attorney's Office, 45th Floor, 219 South Dearborn Street, Chicago, Illinois, on the [illegible] day of June, A.D., 1972, at 11:00 o'clock, a.m.

[illegible]

APPEARANCE: (Continued)

WHITNEY NORTH SEYMOUR, JR.,
United States Attorney,
(SDA Courthouse, Foley Square,
New York, New York 10007), by
DANIEL H. MURPHY, III,
Assistant U.S. Attorney, of counsel to
Whitney North Seymour, Jr.,

appeared on behalf of the defendant.

* * * * *

(Witness sworn.)

MR. MURPHY: I would like to make a statement for the record beginning of this deposition, that this deposition is taken in an action pending in the Southern District of New York, it's pursuant to a subpoena issued out of the Northern District of Illinois.

MARVIN CHANDLER,

called as a witness by and on behalf of the defendant, having been first duly sworn, was examined and testified as follows:

DIRECT EXAMINATION

BY MR. [illegible]:

Q. [illegible]

[illegible]

A Commonwealth.

Q Your address?

A Aurora?

Q Yes, sir.

A Post Office Box 100, Aurora, Illinois, 60507.

Q And are you appearing here pursuant to a subpoena, sir?

A Yes.

Q Do you have that subpoena with you?

A Yes.

Q May I have it, please?

A Yes.

MR. MURPHY: Miss Sapperton, I'll ask you to mark this document as United States Exhibit 1 for the examination of Mr. Chandler at today's date, please.

(The said document was thereupon marked United States Exhibit 1 for identification, as of this date.)

A Yes, I do.

Q And what is it?

A It's a subpoena served on me by the U.S. Marshal of the U.S. District Court for the Northern District of Illinois, Eastern Division, requesting my appearance here today.

Q And are you appearing pursuant to that subpoena, sir?

A Yes.

Q Mr. Chandler, and are you willing to testify voluntarily as a paid witness for the United States in the preceding Cities Service Company against the United States?

A No.

Q And why not, sir?

A Well, regardless of my own personal desire to do so, or not to do so, I decided it would be inappropriate as an officer of the Northern Illinois Gas Company, because of our potential business relationship with Cities Service Company.

We are a seller of gas supplies to a portion of [illegible] and [illegible] for the manufacture of gas.

Cities Service is [illegible]

[illegible] of those associations and is how his relations with them in the past, and I didn't want to take any stand that might injure the present relationships of Northern Illinois Gas Company.

Q Do you have any other reasons besides that one given as to why you might not be willing to testify voluntarily for the Government in this proceeding?

A Well, that relationship I speak of goes both to the corporate property, one might say and also to my own personal situation as a holder of some shares of Northern Illinois Gas stock which are equivalent for dividend purposes to shares of stock and the continuance of the income from those units, or the possession of those units, is contingent on not doing anything that would be harmful to the corporation.

So, of my own sense of concern was both one of corporate property and personal interest. I want to do the right thing by Northern Illinois Gas Company and I want to do the right thing by [illegible] Utilities.

Q [illegible]

A [illegible]

Q And who is your employer?

A Northern Illinois Gas Company.

Q And do you have a position with that company?

A Yes, chairman of the executive committee.

Q And how long have you held that position?

A Since last June, a year ago.

Q And did you have a position with Northern Illinois Gas Company before you were chairman of the executive committee?

A Yes.

Q What was that position?

A Chairman and chief executive officer.

Q And how long were you chairman and chief executive officer of Northern Illinois Gas Company?

A Well, I think it might simplify it because the dates are not precise in my mind to say that I became president in November of 1969, became chief executive officer in addition to the presidency in June of 1974, subsequently, became chief executive officer and subsequently [illegible] chief executive officer [illegible]

you can tell us, briefly?

A It is a major distributor of natural gas over a territory in Northern Illinois. It is about the sixth largest distributor of natural gas in the United States. We do about four hundred million dollars worth of business a year.

Q What geographic territory?

A The northern third of the State of Illinois, exclusive of the Chicago area, and a small area along the North Shore.

Q Does it include the suburbs of Chicago?

A Yes, it includes the suburbs out on out to the Mississippi River, up to the Wisconsin line and down to the central part of the state.

Q Could you briefly outline changes in Northern Illinois Gas Company since you have been its chief executive officer?

A Well, as one [illegible]

relative -- clearly in mind -- but our growth has been very substantial. Our revenues were well under a hundred million in 1955 and, as I say, they are about four hundred million a year now. Our customers were 500,000 in the middle of 1955 and are over a million today.

Q Has there ever been any change in the price of your common stock in that period?

A Yes, when I -- well, it was in the area of $20 a share back in the 1955 period. It is now about $26 after a three for two split, which will make an equivalent of 39, so it's about double.

Q What was your employment before you became executive officer of Northern Illinois Gas Company?

A Immediately prior to becoming president of Northern Illinois Gas in 1955, I was vice-president and secretary and a director of Reid & Chandler, Inc., of New York city.

Q And how long have you an officer of Reid & Chandler?

[illegible] from its formation in 1951.

Q [illegible] you a document which was previously marked for identification, dated October [illegible], with [illegible], June 2, 1955 [illegible]

recognize that document, sir?

A Yes, I do.

Q What is it?

A It is a petition to the Securities and Exchange Commission filed by Reis & Chandler, Inc., explaining the work that the firm did in connection with the Gilbert Service Company Section 11 (b) plan of the Public Utility Holding Company Act and seeking a fee therefor.

Q I refer you to Exhibit A to United States Exhibit 3 for identification which is a description of the firm of Reis & Chandler, Inc. Have you had an opportunity to review Exhibit A to this U.S. Exhibit 3, sir?

A Yes.

Q Does that exhibit reasonably set forth a description of the services rendered by Reis & Chandler [illegible]

A Yes.

Q [illegible]

MR. WINN: I would like to object to this part of it, whatever you are attempting to elicit here. It looks like you are trying to digress from the contents of the document and he is going to put some additional information in it, or somehow change the terms of the document you are asking him to identify and to which he is now referring.

I don't think he can do that unless you have something else you want him to testify to.

MR. MURPHY: I just want to set forth Mr. Chandler's credentials, is what I am setting forth, and that is the purpose of these exams.

MR. WINN: His credentials don't extend beyond the contents of this document, according to your question so far.

MR. MURPHY: That is what that question goes to. I am asking him if there is anything further as to his credentials -- his background -- [illegible] -- is the purpose to which [illegible], to which it is directed.

testify as to the capabilities of Reis & Chandler.

MR. MURPHY: As of 1947?

MR. TYRE: Not as of this document.

MR. MURPHY: I am doing it as of his own knowledge. Any witness is capable of testifying as to his own knowledge.

BY MR. MURPHY:

Q Mr. Chandler, do you have any additions to Exhibit A?

MR. CASEY: Why don't you just ask him if there are engagements beyond this.

MR. TYRE: I didn't we are anticipating our objection but I guess we might as well make it for purposes of the record.

We are going to object, generally, to Mr. Chandler's qualifications as a witness in this suit. He hasn't established any qualifications for him as an expert person.

MR. MURPHY: That is exactly what I am trying to do.

[illegible]

oral testimony and you can't do that.

MR. MURPHY: Well, that objection is reserved for the trial and I think you have adequately made it on the record.

MR. WYNE: Oh, sure, I understand.

MR. MURPHY: Let's proceed.

BY MR. MURPHY:

Q Now, Mr. Chandler, is Exhibit A which you have referred to accurate as to the business done by Rois & Chandler, Inc., up to the early part of 1947 as far as it goes?

A Yes, I think it is or might be. There are other minor things that I am sure that you are aware we did, but this is a good description, good, concise, reasonably complete description of the business of the firm at that time and as it had been.

Q You're one of the founding members of Rois & Chandler?

A Yes.

Q Can you give your age as of [illegible]

A [illegible]

A Well, there were those principals in the firm. We were in corporate form but we operated very close to a partnership in that we were good friends, we got what business we could, we decided how we would handle it, and there was no specific differentiation of responsibility insofar as all the major work of the firm was concerned.

Mr. L. S. Reis was president. He was a little shade older than his brother and myself who were the other principals. He had more leadership was necessary but which almost was always reached much of a consensus of who would do what.

Q In general, what was the work done by Reis & Chandler?

A We were financial advisors and investment counselors. We were retained by various institutions or organizations, to advise them on [illegible] and then was a continuing activity.

[illegible]

Staten Exhibit 1, that document relates to work done for The United Corporation?

A Yes.

Q Did you yourself do any work with respect to The United Corporation?

A I did some of that work, yes.

Q And what part of that work did you do?

A Well, I couldn't say at this time. I recall working on The United Corporation matter. As I recall, we were retained by William Hickey, the president, to do some financial studies, and I believe I put them together.

Q And Illinois Power Company also is mentioned on Exhibit 4. Did you also do work with respect to that company?

A No, that was primarily a Mr. H. J. Dale. He might check with me his conclusions, but it was primarily his responsibility. He talked with the [illegible] and held such [illegible]

[illegible]

[illegible] - direct

C. E. J. Reid.

Q North Penn Gas Company, did you do work for that company?

A No.

Q Pennsylvania Gas and Electric Corporation, did you do any work on that?

A No.

Q The Stockholders of New York and Queens Electric Light and Power Company?

A Yes, that was mine, almost completely. I installed, worked with a helper, and I developed my telephony and worked with the helper in helping him to operate-manipulation of other things.

Q And did you testify in that case?

A Yes.

Q Did you testify in [illegible]

weeks rather than days.

Q Protective Committee for Preferred Stockholders of Rhode Island Public Service Company, did you work on that company?

A No, I didn't.

Q Protective Committee for Preferred Stockholders of Scranton Spring Brook Water Services Company, did you work on that, sir?

A No.

Q Protective Committee For Preferred Stockholders of Gibbs Service Company, did you work on that case?

A Yes.

Q The Middle West Corporation, did you work on that, sir?

A No.

Q The North Continental Utilities Corporation?

A Yes.

Q The Absecon Land and Water Company?

A No.

Q [illegible]

A [illegible]

Q [illegible]

A No.

Q Have you material that exhibit, also?

A Yes.

Q Does it accurately state your qualifications as an expert witness as of 1917?

A Yes.

MR. FIRE: That is in the province of the court to determine. It is his opinion, I suppose, as an expert.

BY MR. MURPHY:

Q Are the facts stated in Exhibit H to United States Exhibit 1 accurate?

A Yes.

Q You worked for Charles D. Barney & Company in 1934 to 1937, is that correct?

A Yes.

Q In that time, did you Charles D. Barney & Company?

A [illegible]

MR. WIRT: Any I say, we have never heard of that organization and we have no knowledge of the qualifications or the depth of expertise of this particular organization you are talking about, and we are just -- we are at a loss to understand how we can accede with this type of issue you are raising here.

I am just stating that for the record. You may proceed.

MR. MURPHY: Fine. Thank you.

BY MR. MURPHY:

Q Is Douglas D. Dewey & Company still doing business?

A Not specifically as such under that name.

Q Is there a successor firm which has taken over the business of Douglas Dewey & Company?

A Yes, it was combined in about 1938, I believe, with H. E. Smith & Company to become Smith, Dewey & Company.

Q And did you work for Smith, Dewey and Company?

A Yes, I did work for Smith, Dewey and Company, but not on the Smith, Barney payroll.

Q And what were the arrangements by which you

did work for Smith, Barney and Company?

A Well, in 1937, the Department of Charles D. Barney and Company at which I was working, the Investment Counsellor Department was separately incorporated as Barrett Associates, Inc., and became a wholly owned subsidiary of Charles D. Barney, and the form then became that Charles D. Barney retained the firm of Barrett Associates to engage in investment research and render investment advice to the firm of Charles D. Barney and Company.

After the merger, the same situation continu for a while, and then subsequently the retainer was not continued after a year or two or three. I don't recall the interval.

Q And Barrett Associates was also a wholly owned subsidiary of Smith, Barney and Company?

A Yes, for a period, and then the relationship was terminated and the firm of Barrett Associates was acquired by its own officers.

Q And what was the business of Barrett Associates?

A Investment counsel.

Q Is that both [illegible]

A No. It brought its [illegible] investments

counsel from individual clients, institutional clients, such as banks and firms for some period of time, the brokerage firm of Charles [illegible] Barney and subsequently Smith, Barney and Company.

Q What were the banks that were clients at that time of their association, if you recall?

A St. Louis Union Trust and Bronx County Trust are the two that come to mind.

Q And what were the institutional clients that you recall?

A I don't recall. My work was investment research. Our reports and recommendations were passed on to the account supervisors, who had the relationships with the accounts.

I was not an officer or a principal in the firms at that youthful period.

Q Fine. Have you given previous testimony or have you given testimony or an expert opinion before in proceedings in court?

A Yes.

Q And in what period did you give such testimony, approximately?

A From about 1945 to '55 -- '54.

Q Do you have a list of the times you made court appearances as an expert utility analyst?

A I have a list, yes. It includes -- in the 37 times -- includes some cases which were not utilities. Reis and Chandler was predominently engaged in utility analysis, but as time went on, we got involved in some other matters as well, and which were not utility matters.

MR. MURPHY: Off the record.

(Discussion off the record.)

MR. MURPHY: On the record.

Ms. Reporter, would you kindly mark this as United States Exhibit 2 for today's date.

THE WITNESS: I guess I should observe that to DD. I almost forgot to put the last one down.

[redacted]

BY MR. DOHERTY:

Q Mr. Chandler, I show you a document marked U. S. Exhibit 2 of today's date, Chandler Examination, and ask you if you recognize that, sir?

A Yes, I do.

Q And what is it?

A It is a list of the various times in which I testified before a court or state regulatory commission, appraisers or some other body, as an expert witness, federal commissions, Canadian Provincial Commissions, some 38 times, rather than 37 since that I said a moment ago.

Q Is that document prepared in your handwriting?

A Yes.

Q In which of these cases did you -- strike that.

I ask you to mark with an asterisk those cases -- those items on this list which [illegible]

analyst with an asterisk?

A I've done so.

Q I note that there are six asterisks on this document.

A Correct.

Q In the other cases, you all testified as a utility analyst?

A Correct.

Q Have you also written any articles on the subject of valuation of utility stocks?

A Yes, I have.

Q Do you have with you a list of those articl written by you?

A I don't have a list of the articles, articl by article. I have a list of publications in which articles I have written appeared, have appeared, I am sure it's not all inclusive and in all cases it w not as a utility stock analyst or a utility securit analyst, as I viewed myself, and I can't remember in each case at this stage what the substance of each article was.

Some have appeared since I have been a utility executive, and some have appeared before I could give you a list of each of those. This is

representative, not an all-inclusive list of publications, if you'd like, about a half a dozen.

Q Do you have a list of publications which we could mark for identification here that your articles have appeared in?

A As a part of another, there are only six names.

Q Let's see.

A It is part of an extensive biography my secretary keeps up.

Q May I mark this, sir, as United States Exhibit 3 for identification?

A Sure.

MR. MURPHY: Mr. Reporter could you mark this document, please, as U. S. Exhibit 3 for identification.

(The said document was thereupon marked United States Exhibit No. 3 for identification, Shuler Direct. [illegible])

A Yes, I do.

Q What is it?

A Well, it is a listing of my biography and various activities that I have engaged in over the years. It gives business experience, directorships, industry and association activities, civic activities, and other professional activities, such as addresses, and articles written and the like.

Q All right. U. S. Exhibit 3 for identification includes articles written by you?

A It includes a list of most of the journals in which articles by me have appeared.

Q Does it also include a list of addresses given by you?

A It includes a list of meetings and groups which I have addressed.

Q I show you two documents which have previously been marked as Exhibits D to the affidavit of [illegible] in support of the [illegible] motion for summary judgment in this case and ask you if you can identify [illegible] exhibits.

A [illegible]

[illegible] and Gridley.

Q Is that here a SEC Exhibit C in this document which I show?

A Yes, I recognize them.

Q What is Exhibit D, also?

A It is the Cities Service Company plan, pursuant to Section 11(3) of the Public Utility Holding Company Act of 1935, the simplification of corporate structure, dated November 20, 1946.

MR. TWIN: Let the record show that the witness is reading that statements from the document.

MR. MURPHY: Fine.

BY MR. MURPHY:

Q And Exhibit D, also?

THE WITNESS: The witness can read.

MR. TWIN: Sure.

BY THE WITNESS:

A [illegible]

Q And when were they so employed?

A It was along in January of 1947.

Q And by whom were they so employed?

A By the Protective Committee for the Preferred Stockholders of Cities Service.

Q What was the nature of the employment of Reis and Chandler?

A Well, we were asked to examine the first plan, to see whether we thought it treated the preferred stockholders fairly and equitably, and prepare testimony with respect to our conclusions to be given by the Securities and Exchange Commission, when it considered the plan.

Q And did you yourself work on that project for Reis and Chandler?

A Yes.

Q And what did you do with respect to that project?

A I looked primarily at the preferred stock, as to what the shareholders had and were giving up, what the value of the preferred shares was at that time.

Q And you reach an opinion in 1947 as [illegible] the preferred and preference stock [illegible]

could and should have been paid in cash by Gibbs Service Company?

A Yes.

Q And what was that opinion?

A I concluded that they could have been and should have been paid in cash.

Q What were the facts on which you based that opinion?

A I studied the cash, which seemed to be adequate, and working capital seemed to be adequate. It didn't seem to unduly impair or impede the Gibbs Service to pay the arrears.

Q I show you the affidavit of Bowen J. Gallagher, previously referred to.

MR. RYAN: Will you identify Bowen J. Gallagher for the record? I don't think you did before; I'm not sure.

MR. HARRIS: No.

MR. RYAN: I don't think you did. I'm not sure it is the same.

[illegible]

Southern District of New York, attorney for defendant herein, in the case of Gibbs Service Company, plaintiff, against United States of America, defendant, in the United States District Court, Southern District of New York, 67 Civil 4606.

MR. TYRE: Thank you.

MR. MURPHY: Off the record.

(Discussion off the record.)

MR. MURPHY: I am going to ask you to read pages 3 through 20 of this affidavit, paragraphs 18 through 45, and at the end of that, I am going to ask you if you considered the facts, amongst other facts, in reaching your opinions in this case.

MR. TYRE: Before he gets started, I am going to maintain my objection to this.

[illegible]

spent seven minutes reading the material handed to him by Mr. Murphy.

BY MR. MURPHY:

Q Mr. Chandler, did you consider the facts set forth in those paragraphs 18 through 45 in reaching your conclusion?

A Yes, I did. I obviously don't recall every specific number, and I didn't review every specific word in here, but these are essentially the facts as I recall them, yes.

Q All right. I also show you Exhibit I to Government's Exhibit 1 of June 2, 1972, in Reis' examination, and ask you if you recognize that exhibit?

A Yes, I do.

Q And what is that?

A That is an outline of the testimony that I was prepared to present before the Securities and Exchange Commission in the matter.

Q [illegible] the 1967 employment by the Federal [illegible] Securities Commission of Silas [illegible] Security

A [illegible]

Q [illegible]

that testimony?

A Yes, there were several proposed exhibits.

Q Now, were the exhibits a part of Government's Exhibit 1, marked as Exhibits J, K, L and M?

A Yes.

Q And N, too, is that correct?

A Yes.

Q Did you also consider the matters set forth in Exhibit I and Exhibit J through N, in reaching your conclusion?

A Yes.

MR. ZWIBE: What conclusion? His conclusion here or his conclusion there? I'm lost here.

I'm sorry for interrupting, but I am trying to follow the train of this.

BY MR. MURPHY:

Q What conclusion on whether preferred and preference dividends accrued and should have been paid in cash by Gibbs Service Company in 1967?

A Yes.

Q Did you also consider in that [illegible]

[illegible]

[illegible]

A Yes.

Q And what was your opinion as to that fair investment value, assuming that the arrears had been paid and regular dividends were being paid on such preferred and preference stocks?

A My conclusion was that they would have an investment value in excess of the call price.

Q What were the facts on which you relied in support of that opinion, sir?

MR. TYRE: Excuse me. Is all that in the exhibit, what he is testifying to?

MR. MURPHY: What?

MR. TYRE: What you are saying is that in the exhibit, that thing he has there --

MR. MURPHY: This is his oral testimony as to a fact.

MR. TYRE: Well, what you are saying is, you are asking him if he came to a conclusion back in 1927, and he is referring to this exhibit and saying, 'Yes,' or 'No,' or, 'Sure,' or whatever his answer is.

I don't have a copy of that, you understand, and I am saying to him, 'Is that what he is testifying to, that [illegible]

this is an opinion he is reaching right now and here, this very minute, on the basis of the documents you are showing him.

I am at a loss to understand how I can ask him any questions on cross examination, which you say is the only avenue I have here, if I don't know what he's doing and you won't tell me.

BY MR. MURPHY:

Q Do you remember, Mr. Chandler, independent of United States Exhibit 1 for identification, whether you reached an opinion as to the value in 1947 of the preferred and preference stocks?

A Yes.

Q And did you reach an opinion?

A Yes.

Q And you remember that, independent of this exhibit, which is in evidence?

A Yes.

Q What is that opinion, again, sir?

A I reached the conclusion that [illegible] would and should have been paid and that the [illegible] value of the preferred and preference stocks were the arrears paid and regular dividends paid, as

be in excess of call price.

Q And what were the facts?

A Call prices.

Q What were the facts on which you based that opinion?

A Well, I studied the situation of Cities Service, its financial statements, the coverage of preferred dividends by any income which was and would be available, and I made some comparisons with other preferreds, with ready markets, to see where they were selling on a yield basis, and concluded that on a yield basis that dividend rates on the Cities Service issues would carry them to a price moderately above the call prices.

Q And the grounds for your opinion, sir, in regard to those, substantially the same as the facts in this case on which you base your answer to which you just gave and on which you based your opinion?

A Could you read that again?

(Record read as requested.)

MR. MURRAY: Let me strike that question.

BY MR. MURRAY:

Q The reasons or grounds that you had when

supported the opinion you reached back in 1947?

A Well, the opinion was supported by the studies I made, which are shown in Exhibit 1, and they related, as I indicated, to dividend coverage on a corporate and consolidated basis, and financial ratios, various financial ratios, such as the capitalization ratio, comparison of similar statistics on other companies, the market prices of other companies preferred, were selling at, yield on preferreds in general at that time; a raft of factors which a financial analyst would look at to reach an investment value decision.

Q Do you have an opinion of the value to Cities Service Company of the preferred and preference stocks received by it on May 27, 1947?

MR. TYNE: Let me object. The witness has not shown any qualifications for making such a determination or arriving at such an opinion.

MR. MURPHY: All right, Mr. Tyne, if you would like to go into that on voir dire now, go ahead.

MR. TYNE: You already said no before that. Are you allowed to do this.

MR. MURPHY: Go ahead.

MR. TYNE: Well, I [illegible]

the document that you are examining him from. That is my problem with this case at this point. I don't even know where we are.

MR. MURPHY: Do you have any statements, any questions you would like to ask on voir dire, as to the witness' qualifications, at this time, Mr. Tyre?

MR. TYRE: Well, I said he is not qualified. I don't know what his qualifications are. I don't even know what we are talking about. That is the problem.

You have shown him some affidavits of Bryan Gallagher, who is an employee of the U. S. Attorney, and he read them for approximately seven minutes; and now you are asking him to come to a conclusion based on some outlines that were submitted to the S.E.C. in 1947.

I don't know what he is basing his testimony on. I don't even know what it is and I don't think he has indicated he was ever employed by Gibbs service, to determine what he [illegible] was to show.

That is beside the point. [illegible] is not in validity or accounting they did [illegible]

preferred shareholders committee back in 1947, when he was with Reis and Chandler, but he wasn't employed by Cities Service that I know of.

MR. MURPHY: All right. Do you have anything else to say on your objections to his testimony as an expert?

MR. TYRE: No.

MR. MURPHY: Okay.

BY MR. MURPHY:

Q Now, Mr. Chandler, I ask you, do you have an opinion of the value to Cities Service Company of their preferred and preference stocks and the dividend arrearages on them, received by Cities Service Company on May 27, 1927?

A Yes.

Q And what is that opinion, sir?

A I think Cities Service got a good buy, a good bargain in getting the preferreds discharged at less than call price plus arrears.

I think it would have been a good bargain for Cities Service at call price plus arrears. I think the value to Cities Service is call price plus arrears and accrued [illegible] call price plus [illegible].

Q Is it your opinion that the value to Cities Service of that preferred and preference stocks and the dividends in arrears was worth 100 cents on the dollar?

MR. CASEY: I object to that. You've asked for his opinion and he's given it. He is your witness.

MR. MURPHY: He is not my witness. He's under subpoena. He is nobody's witness.

MR. CASEY: You've asked him the question on direct and he's answered that. That is as far as you need to go, as far as you can go.

MR. MURPHY: No, sir. Objections are reserved for trial.

All right, let's put it this way: Could you read back my initial question and Mr. Chandler's answer?

(Record read as requested.)

MR. CASEY: So you have subpoenaed him here as your witness. You've asked him the question. He's answered his question.

We are certainly not going to let you rephrase his answer.

MR. MURPHY: No. All right.

BY MR. MURPHY:

Q Is that your complete answer on that opinion?

MR. CASEY: I object to that, too. He gave you a complete answer to that opinion.

MR. MURPHY: That objection is reserved for trial.

MR. CASEY: No, it isn't. There are some rules that are bound to be operative in the absence of a judge, and this business of calling in an expert witness, spending all morning attempting to qualify him, and then try to add to or restate his answer, is certainly one of those screams, and it's ridiculous.

MR. MURPHY: Well, we will put it on the record for what it is worth. If the Judge thinks --

MR. CASEY: I am objecting to it going any further.

Now, certainly you ask the man who is your area to an expert for his answer. His [illegible] conclusion.

Now, you [illegible] to [illegible] the [illegible] and I am objecting [illegible] on the [illegible] Rule.

MR. CASEY: We've wasted enough time in this case already.

BY MR. MURPHY:

Q Is that answer complete, in your opinion, Mr. Chandler?

MR. CASEY: I'm saving my objection.

MR. MURPHY: All right.

THE WITNESS: Do you want to read the answer again?

(Record read as requested.)

THE WITNESS: I'm satisfied with the answer.

MR. MURPHY: All right, fine. No further questions.

MR. TYNE: Do you have any questions, Mr. Casey?

MR. CASEY: Let's take a couple of minutes.

MR. TYNE: Yes, a couple of minutes!

MR. CASEY: I have a couple, too, but let's take about a three-minute recess.

(A short recess was taken.)

MR. CASEY: I have a couple of questions.

CROSS EXAMINATION

BY MR. UZZE:

Q Mr. Chandler, in the beginning of your deposition, you made some statements about your willingness to testify in this case, because of the Cities Service aspect.

To clear up any possible misunderstanding, did you contact the Cities Service Company apropos your possible testimony?

A No.

Q And they didn't contact you?

A No, no contact with them or their attorneys or anybody in this organization.

Q This testimony was just your personal view?

A Personal assessment of the situation.

Q Personal assessment?

A Yes.

Q Thank you.

MR. MURRAY: Excuse me, the date on that is 1947, this is?

MR. UZZE: Yes, sir.

MR. MURRAY: Oh, I see it.

MR. UZZE: Is [illegible] Chandler's [illegible]

[illegible]

MR. MURPHY: This is as to the testimony of today you are talking about?

MR. TYRE: Yes.

BY MR. TYRE:

Q With regard to the United States Exhibit 1 that you've referred to frequently here, did you actually prepare that exhibit yourself?

A Well, I prepared myself those parts of it marked I through M, and I participated in the preparation of pages 1 through 4.

Q Doesn't that exhibit --

A That is about all.

Q Doesn't that exhibit represent a group effo by the firm of Reis and Chandler?

A Well, I don't know quite what "group effor means.

Q It's prepared by more than one person?

MR. MURPHY: Which exhibit? Which exhibit are you talking about?

MR. TYRE: Your exhibit. I don't have it.

MR. MURPHY: U. S. Exhibit 1, you mean?

MR. TYRE: Yes.

BY MR. MURPHY:

A Yes, portions. There is an exhibit -- I

to this extent -- there is an outline of the proposed testimony that Mr. Reis was going to give, and some exhibits of his.

There was my outline and exhibits, which each worked pretty independently, as I recall, because the time was very tight, and then a petition for a few which came some time later.

As I recall, we both took a crack at it.

BY MR. TYRE:

Q Did you testify before the S.E.C.?

A No, not in that case, not in the Cities Service case.

Q Do you recall for what purpose this exhibit was submitted to the S.E.C.?

MR. MURPHY: Which exhibit, again?

MR. TYRE: This Exhibit 1.

MR. CASEY: Can we go off the record for a minute?.

MR. MURPHY: Yes.

(Discussion off the record.)

BY MR. TYRE:

Q Mr. Chandler, for purposes of clarity [illegible] refer to Exhibit 1 [illegible]

A [illegible]

Exhibit 1 to Mr. Reis' exhibit -- Exhibit 1 to Mr. Reis' deposition dated June 2, 1972.

You understand that now, I'm referring to that exhibit and not to any others?

A That is what I've understood it to be, yes.

Q Do you recall the purpose for which this exhibit was submitted to the S.E.C.?

A Yes. The purpose of submitting the exhibit to the S.E.C. was to substantiate -- to request a fee.

Q To your knowledge, did the S.E.C. entertain the merits of that exhibit, consider it?

MR. MURPHY: If he knows.

MR. TYRE: That's right.

MR. MURPHY: I'll object.

BY THE WITNESS:

A I have a lot of trouble with that. The S.E.C. is a pretty broad organization, commissioners, staff, counsel.

BY MR. TYRE:

Q We just don't know.

A My recollection is that Mr. Abbenhaus, counsel for the Special Committee, utilized it in discussions and also with the staff of the Commission staff and counsel of the Commission, as well as the

I can say.

Q Were you present at the S.E.C. hearings, when this exhibit was offered or filed?

A There were no hearings on this exhibit, I don't believe, on the fee. I just don't recall. I don't recall.

Q Do you know whether there was any examinati or cross examination with regard to it?

A I don't know.

Q With regard to your qualifications explored before, could you say again when you left the firm of Nels and Chandler?

A November, 1954.

Q Have you testified as an expert witness in any proceeding since that time?

A Once or twice subsequent thereto, yes.

Q On behalf of clients or on behalf of your employer?

A On behalf of Wm Penn-Texoil Oil and Gas Group in '54, and I think again in '55, although it's not listed on there.

Q '55 would be the last time, then?

A Yes.

Q In your direct examination, your attorney

was called to plans of simplification, attached to an affidavit or something.

Now, for purposes of clarifying the record, did you participate in the drafting or writing of those plans in any respect?

A No.

MR. MURPHY: Would you refer to the exhibit number, Exhibit G and D. Do you have them?

MR. TYNE: Refer to them as plans of simplification.

MR. MURPHY: By that you mean Exhibits D and G?

MR. TYNE: Whatever they are. I don't have it before me.

THE WITNESS: This?

MR. MURPHY: Yes, it's there.

THE WITNESS: Here is G and F.

MR. MURPHY: I think it's D and G, D and G

BY MR. TYNE:

Q Exhibits D and G to Mr. Gallagher's affida[illegible] in this case. You stated that you reviewed those [illegible] to determine whether they were fair and equitable

Shall I repeat the question?

[illegible] Just a minute.

(Discussion off the record.)

MR. MURPHY: Could I make a statement on the record?

MR. TYRE: Yes.

MR. MURPHY: As a housekeeping matter, wher I have been referring as Exhibit D to Mr. Gallagher's affidavit, it should read Exhibit C and where I have been referring to Exhibit G to Mr. Gallagher's affidavit, it should read Exhib. F.

THE WITNESS: The same for me.

MR. TYRE: Likewise, I'm sure.

BY MR. TYRE:

Q You stated in your direct testimony that you reviewed these plans of simplification to deter whether they were fair or equitable.

Is that an S.E.C. term, "fair and equitab

A I believe it's an S.E.C. and court term under the Public Utility Holding Company.

Q I see. Now, this burden took place in 1947, I think you, for purposes of simplification

A Yes. I took a look at them prior to the application.

Q Now, with regard to your participation i

the S.E.C. proceedings or the S.E.C. matter in 1947, you worked or were employed by a committee of preferred shareholders?

A Yes.

Q Now, wasn't your function to determine the investment value to those shareholders of their preferred shares?

A That was a function; not the sole function.

MR. TYRE: I have no more questions, but I would like to state for the record that we have not yet been furnished with a copy of the United States Government's Exhibit 1, and accordingly we have no basis upon which to examine the proposed witness, as to its contents.

Accordingly to the extent that any testimony today varies from the document submitted, we move that such testimony be stricken from the record.

MR. MURPHY: All right. I have a copy of U. S. Exhibit 1, an extra copy here in my files, and it is a public record on file before the Securities and Exchange Commission in this Service matter, but I'll see it will make it available to counsel, and I hereby hand it over.

MR. TYRE: I will again say for the record that I am not prepared to cross examine the witness as to his testimony with regard to this, because I have not received it until this morning.

MR. MURPHY: You acknowledge receipt of it now, though?

MR. TYRE: I will acknowledge receipt of it now.

MR. MURPHY: Any further questions, folks?

MR. TYRE: Do you have any questions?

MR. CASEY: I just wanted to ask one questi again in clarification.

CROSS EXAMINATION

BY MR. CASEY:

Q You talked about the investment value of th preferred shares, and you were looking at this invest ment value from the standpoint of your client; in this proceeding, I take it?

MR. TYRE: In 1947?

BY MR. CASEY:

Q In 1947?

A I don't think that -- no, I don't think [illegible]

come up, depending on who the client is.

Q I agree with that. But you were looking at investment value to a holder of the preferred, whether a then holder or a future holder in the marketplace, isn't that correct?

A To this extent: My testimony was and the outline of 1947 was that the investment value of the preferred with arrears paid was such and such, was call, plus arrears, plus something.

Yes, that investment value is an attempt to decide what a fair value will be in a marketplace, between an unpressured buyer and an unpressured seller

MR. CASEY: That is the only question I have.

MR. MURPHY: We will give this transcript to Mr. Chandler and any corrections or whatever he can note on there, and ask him to sign it before any notary public.

Is it stipulated that any notary public in Illinois, without the necessity to have it authenticated by a judge?

MR. [illegible]: We will stipulate to that.

MR. MURPHY: Okay, Mark.

(Witness excused.)

A 634 51

UNITED STATES DISTRICT COURT FOR THE

SOUTHERN DISTRICT OF NEW-YORK

CITIES SERVICE COMPANY, Plaintiff, -v- UNITED STATES OF AMERICA, Defendant.	67 CIV. 4606 CHT

This is to certify that I have read the transcript of my deposition taken in the above-entitled cause, and that the foregoing transcript, consisting of pages 1 to 50, inclusive, accurately states the questions asked and the answers given by me.

WITNESS EXAMINED

SUBSCRIBED AND SWORN TO
before me this ____ day
of _____, 19__.

NOTARY PUBLIC

UNITED STATES OF AMERICA
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION
STATE OF ILLINOIS
COUNTY OF COOK
} SS:

I, Jeanette Hansen, a notary public in and for the County of Cook and State of Illinois, do hereby certify that HARVIN CHANDLER was by me first duly sworn to testify the whole truth and that the above deposition was recorded stenographically by me and was reduced to typewriting under my personal direction, and that the said deposition constitutes a true record of the testimony given by said witness.

I further certify that the said deposition was taken at the time and place specified hereinbefore, and that the taking of said deposition commenced on the 28th day of June, A. D. 1972, at 11:00 o'clock a.m.

I further certify that I am not a relative or employee or attorney or counsel of any of the parties, or a relative or employee of such attorney or counsel, or financially interested directly or indirectly in the action.

A 636 53

IN WITNESS WHEREOF, I have hereunto set my hand and affixed my seal of office at Chicago, Illinois, this 29th day of June, A. D. 1972.

Jeanette Hansen

Notary Public, Cook County, Illinois
My commission expires Aug. 22, 1972

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

CITIES SERVICE COMPANY,

Plaintiff,

-against-

UNITED STATES OF AMERICA,

Defendant.

67 Civ. 4606 (CHT)

OPINION

TENNEY, J.

This is an action pursuant to 26 U.S.C. § 7422 (1970) and 28 U.S.C. § 1346(a)(1) (1970) for refund of income taxes paid by plaintiff for the calendar years 1953 and 1954. Plaintiff, in 1947, issued 30-year 3 percent debentures with a face value of $115,246,950 in exchange for shares of its own $6 preferred stock, $6 preference BB stock, and 60¢ preference B stock.[1/] By the terms of the indenture, plaintiff was required to retire annually $1,500,000 principal amount of debentures. In 1953 and 1954 plaintiff purchased in the open market and retired in excess of $1,500,000 principal amount of debentures. Plaintiff asserts that when the debentures were issued in 1947 it received less in value for them than their face value, and alleges that the difference between the face amount of the debentures and the consideration received by it on the exchange is a "loss" within the meaning of 26 U.S.C. § 165(a) (1970), which loss may be realized as the debentures are redeemed or

amortized over the life of the debentures. Treas. Reg. § 1.61-12(c)(3) (1968).

This case is before the Court pursuant to an order entered on February 11, 1971, by United States District Judge (now Circuit Judge) Walter R. Mansfield. The order was entered pursuant to an opinion dated July 23, 1970, in which Judge Mansfield denied motions for summary judgment made by plaintiff and defendant. Cities Service Co. v. United States, 316 F. Supp. 61 (S.D.N.Y. 1970). The order decreed:

> "...that this case be set down for trial in due course with the sole factual question to be resolved thereat being the value to plaintiff of the preferred and preference shares received by it in exchange for the issuance of its 3% Thirty Year Sinking Fund Debentures ("the Bonds") on May 27, 1947; and
>
> "...that...the bonds shall be deemed issued at a price equal to the value to plaintiff of the preferred and preference stocks received in exchange for their issuance on May 27, 1947; and
>
> "...that...the value of those shares to plaintiff shall be no less than $45,323,846, the value of the consideration originally received for their issuance ...."

On February 9, 1971, defendant's second motion for summary judgment was heard by United States District Judge Inzer B. Wyatt and denied on June 21, 1971, in an opinion reaffirming Judge Mansfield's determination. Cities Service Co. v. United States, 330 F. Supp. 421 (S.D.N.Y. 1971).

Although both Judge Mansfield's and Judge Wyatt's opinions, findings of fact and conclusions of law are incorporated herein, it will be helpful to repeat certain of the conclusions

reached by Judge Mansfield in order to define the specific issue remaining.

From the evidence before him, Judge Mansfield concluded, first, "that the shares were worth less than the face amount of the debentures", and, second, "that the 1947 exchange did not constitute a redemption". 316 F. Supp. at 66. "In conclusion we view the 1947 issuance of debentures as an exchange and not a redemption.... However one chooses to measure the consideration they gave up, there is every indication that it was substantially less than the face amount of the debentures they received." Id. at 69. On the motion for summary judgment, plaintiff, relying principally on the Court of Claims' decisions in Erie Lackawanna R.R. v. United States, 422 F.2d 425 (Ct. Cl. 1970) and Missouri Pacific R.R. v. United States, 427 F.2d 727 (Ct. Cl. 1970), cert. denied, 402 U.S. 944 (1971), argued not only that the original cost of the preferred and preference shares represented the minimum value for determining its loss or discount, but also that this figure represented the maximum. Judge Mansfield disagreed with the latter proposition holding:

> "Although a taxpayer, upon issuance of bonds in exchange for its shares, may not claim a loss based upon a decline in the market price of the shares below the price realized by it upon their original issuance, [citing Erie Lackawanna and Missouri Pacific, supra] it does not follow that the shares or obligations cannot turn out to have a greater value to the taxpayer than their original issue price". 316 F. Supp. at 72.

It is interesting to note that on the basis of Judge

Mansfield's opinion the Court of Claims modified its prior opinion in Missouri Pacific, supra, and held that the original issue or cost price did not represent the ceiling value for the purpose of calculating debt discount. Missouri Pacific R.R. v. United States, 433 F.2d 1324 (1970), cert. denied, 402 U.S. 944 (1971). Judge Mansfield further observed that

> "even though the accrued and unpaid accumulated dividends did not constitute a firm obligation for which the plaintiff had received any consideration, the preferred and preference shareholders could use the dividend provisions of the charter to preclude plaintiff's management from paying any dividends on the common and to restrict the uses to which plaintiff's earnings could be put." 316 F. Supp. at 72.

He concluded that "[t]he actual value to the taxpayer can be determined only after consideration of all relevant data, including the market value of the shares, the financial condition of the taxpayer at the time of the exchange, its profits prospects and expert opinion." Id. at 72-73.

In accordance with Judge Mansfield's opinion and the order entered pursuant thereto, plaintiff called three experts in the fields of corporate finance, value analysis, economics and business management and has submitted other evidence. These experts appraised the exchange from three different viewpoints:

1) The general economic aspects of the exchange, an analysis of the specific economic and financial benefits and burdens resulting to plaintiff therefrom and the net effect of the exchange in light of the prevailing economic conditions on May 27, 1947;

2) An economic and financial analysis of plaintiff and the securities involved to ascertain what value, if any, apart from the amount or value received when the preferred and preference shares were issued, accrued to plaintiff on account of the exchange; and

3) An analysis of the effect of the issuance of the debentures on plaintiff's financial and economic structure.

General economic aspects and specific benefits and burdens resulting to plaintiff from exchange.

According to plaintiff's expert, Dr. Jules Backman, there were, of course, benefits which accrued to plaintiff upon the exchange: it enabled plaintiff to conform to and comply with the Public Utility Holding Company Act; it got plaintiff the benefit of a tax deduction for interest payments; and the elimination of the preferred and preference stocks permitted plaintiff to pay dividends to the common stockholders if money were available for that purpose. It seems clear, however, that the net effect of the exchange was adverse to plaintiff. Plaintiff exchanged its senior stocks (i.e., the preferred and preference stock) on which, except for one small payment, it had not paid a dividend since 1932 and on which, under normal circumstances, it would not be required to pay dividends for the foreseeable future, for debentures, fixed and determinable debt obligations with mandatory annual interest payments and mandatory

sinking fund requirements. So although plaintiff became entitled to a tax deduction for the interest payments on the debentures, it was henceforth required to pay such interest in addition to having to establish a sinking fund to redeem the debentures. Whereas with the preferred and preference shares outstanding, plaintiff had had the continuing option to avoid paying out cash to its equity holders and to use the funds to pay off debts or to expand its plant and equipment, the exchange resulted in a constant cash drain on the company of more than $3,600,000 annually. Moreover, the issuance of the debentures gave plaintiff an exceedingly high proportion of debt to equity capital, and the indenture of the new debt burdened plaintiff with additional restrictions on its future debt financing based upon an earnings level ratio.

Economic and financial analysis of plaintiff and the securities involved.

In his opinion Judge Mansfield noted that "the face amount of the debentures issued in 1947--$115,246,950--was identical with the cash amount that plaintiff would have been required to pay to the preference and preferred shareholders if it had chosen to redeem their shares." Id. at 66. Plaintiff's expert, William R. Field, broke down the principal amount in slightly greater detail as follows:

1)	Original discount on preferred and preference stock when issued	$ 13,366,154
2)	Stated call premium	6,885,000
3)	Accumulated dividend arrearages	49,671,950
4)	Original consideration for the issuance of the preferred and preference stock	45,323,846
		$115,246,950

In accordance with Judge Mansfield's decision, the original consideration, i.e., $45,323,846, is the "floor" with respect to the issue before this Court. Accordingly, at trial plaintiff's expert directed himself to the question of whether plaintiff could have realized or acquired value on account of the excess between the "floor" and a "ceiling" represented by the $115,246,950 of debentures. Insofar as the stated call premium of $6,885,000 was concerned, he was of the opinion that it was a "penalty" payable on redemption and not value received by plaintiff. Even if plaintiff had liquidated, the stockholders would not have received a call premium. Since it already has been held that there was no redemption, this premium would appear to have been a windfall for the stockholders.

The dividend arrearages of $49,671,950 present a more serious problem. It is not disputed that accumulated, undeclared dividends on preferred or preference stock do not constitute a binding legal obligation of plaintiff, unless the dividends were withheld in bad faith. Id. at 70 n.8. Upon analysis of investor behavior, plaintiff's financial condition and the charter provi-

sions relating to the preferred and preference stock, plaintiff's expert concluded that nothing of value was received by plaintiff on account of the accumulated, undeclared dividends. His conclusion that no value accrued on account of the arrearages was predicated upon the following factors:

1) Analysis of the market prices showed that investors were not anticipating the payment of arrearages. In the opinion of the expert, a comparison of the market activity and prices of the stock when dividends were being paid and arrearages had not accumulated, with such activity and prices when there were no dividends paid and arrearages had accumulated, indicated that investors in plaintiff's preferred and preference stocks were not anticipating the payment of arrearages. The foregoing conclusion was corroborated by the expert's analysis of the price-yield ratios or relative yield factors of the preferred and preference stocks and the general yield percentages of other high grade preferred stocks using the stated dividend rate whether or not paid.

2) Analysis of plaintiff's financial structure indicated that it was not possible for it to pay the arrearages. Such analysis was predicated inter alia upon a study of plaintiff's annual earnings record, net income, accumulated arrearages, net income as a percentage of arrearages, net income available for dividend arrearages, after-tax interest coverage, and a comparison of plaintiff's financial situation with that of three

independent yardstick groups of companies (i.e., thirty petroleum companies, all natural gas companies reporting to the Federal Power Commission, and all Class A and B electric companies similarly reporting) to determine whether plaintiff was in such comparatively good financial condition that it could, should, or would pay the accumulated dividend arrearages. The yardstick companies were compared with plaintiff as to interest coverage, rates of return on equity capital and on total capital, relative percentages of net income plus interest as percentages of total income, interest as a percentage of average debt capital, long term debt capital as a percentage of total capital, and common and preferred capital as a percentage of total capital. The yardstick companies interest coverage for the period 1940-1946 greatly exceeded that of plaintiff, indicating a need for plaintiff to reduce debt charges and consequently to increase its coverage. Comparison of plaintiff with the yardstick companies as to rate of return earned on average common and preferred capital and rate of return earned on average total capital showed that plaintiff's earnings were substandard. Net income as a percentage of total income (net income plus interest), interest as a percentage of net income plus interest, and interest as a percentage of average debt capital when compared as between plaintiff and the yardstick companies indicated that plaintiff's relative net income was extremely low or, conversely, that its debt structure and in-

terest charges were very high when compared to other competitive companies. Likewise, the paralleling of capital structure ratios and the percentages of total capital represented by debt and equity evidenced the high debt or low equity level of plaintiff compared to the criteria groups. Plaintiff's capital structure proved to be several times heavier with debt than that of the yardstick petroleum companies and significantly heavier than the yardstick gas and electric companies, while its equity as a percentage of total capital was much lower than that of the yardstick companies. On the basis of the foregoing, plaintiff's expert concluded: (a) that plaintiff was not in a position either to pay the dividend arrearages or to issue debt obligations for them; (b) that the retirement and cancellation of the stock did not release to, or provide plaintiff with, any additional funds for the payment of its obligations or for dividends to common stockholders; (c) that since the stock "disappeared" upon the exchange, no "investment value" accrued; and (d) that cancellation of the stock converted into a firm, binding debt obligation which must be paid at all events, a contingent claim relating only to relative priorities among shareholders in any distribution of earnings which, if left to its own devices plaintiff most likely would have disposed of at little cost to itself.

Effect of the issuance of the debentures on plaintiff's financial and economic structure.

Finally, plaintiff presented through the expert testimony of William A. Gill an analysis of the effect of the issuance of the debentures on its financial and economic structure. It was the expert's opinion that as a result of the exchange plaintiff's financial condition had deteriorated.

It should be noted that at the trial none of plaintiff's three experts offered an opinion as to the "fair market value" of the preferred and preference stock as of May 27, 1947, but only as to the "value to plaintiff" of such stock. As will appear infra, however, such opinion evidence of "fair market value", not specifically rebutted by any of the parties, does form a part of the trial record herein.

Defendant relied upon the testimony of three expert witnesses, as did plaintiff. Although the issue before the Court was the value to plaintiff of the preferred and preference shares, none of defendant's witnesses directed himself to that issue but spoke of "investment values" to the stockholders, or benefit to the common stockholders. Two of defendant's experts went so far as to testify that the value to the taxpayer (by way of value to the common stockholders) was in excess of the face amount of the debentures, while the third expert testified that plaintiff would in his opinion clear up the accumulated arrear-

ages within ten years, and, accordingly, that the value of the preferred and preference stock to plaintiff was $115,246,950--i.e., the face value of the debentures.

The Court rejects the opinions of defendant's experts in their entirety. Their opinions cannot withstand analysis, are based upon false premises, or fail to reach the issue herein --as has clearly been demonstrated by plaintiff in its "Requested Findings of Fact and Conclusions of Law and Brief in Support Thereof" at 37-59 and "Reply Brief" at 12-17.

Despite the failure of the experts for either party to fix during the trial the fair market value of the stock on May 27, 1947, there is, as has been indicated, expert evidence on record fixing such value. In its papers on the motion for summary judgment before Judge Mansfield plaintiff asserted that the fair market value of the preferred and preference stock at the time of the exchange was $86,313,600. (Def.'s Exh. B, "Rule 9(g) Statement" ¶ 51.) More specifically plaintiff put forward the following valuations as of May 27, 1947:

Class of Stock	No. of Shares	Fair Market Value Per Share	Aggregate Fair Market Value
$6 Preferred	560,000	$147.50	$82,688,500.00
60¢ Preference B	86,000	$13.75	1,182,500.00
$6 Preference BB	17,700	$138.00	2,442,600.00
		Total	$86,313,600.00

The basis for the above valuation was an affidavit of William A. Gill dated January 27, 1970, and supporting data. (Def.'s Exh. B, "Rule 9(g) Statement" Exh. 1.) Other than a passing reference, no mention of this valuation was made by either party in its briefs before this Court, although the Court specifically called it to the attention of counsel in the course of the trial (Tr. 241-42). Moreover, pursuant to Judge Mansfield's opinion, defendant had "the right...to challenge these figures and to exercise its rights under Rule 56(f), F. R. Civ. P., to cross-examine or depose the experts upon whom plaintiff relies." 316 F. Supp. at 74. Gill's expert opinion remains unrebutted, plaintiff now adhering to its claim that the "floor" of $45,323,846 is determinative, whereas defendant maintains that the "ceiling" of $115,246,950 or some greater figure should control. In this respect plaintiff apparently has abandoned the first of two theories in support of its claim. As stated by Judge Mansfield:

> "Plaintiff advances two theories in support of its claim to a tax deduction arising from its repurchase of debentures in 1953 and 1954. Both theories are based on plaintiff's contention that it paid more to redeem the debentures than it received in exchange for them upon issuance in 1947. What it received--the issue price of the debentures--plaintiff contends, was either the fair market value of the preferred and preference shares surrendered upon the 1947 exchange ($86,313,600.00), or the fair market value of the cash and properties originally paid in upon issuance of those shares in prior years ($45,323,846.00). The first theory holds simply that a deductible loss was realized upon repurchase of debentures at a price higher than the price realized upon their issuance. The second theory, based on Reg. § 1.61-12, holds that the issuance of the debentures at less than face in

> 1947 gave rise to bond 'discount' within the meaning of that Regulation, entitling plaintiff to prorate or amortize the discount over the life of the bonds and to deduct both the amortization thereof for the taxable years in question and the unamortized portion of the discount attributable to the debentures retired in those years. Each theory produces two figures for the proposed deduction, depending on which of the two measures of the issue price of the debentures in 1947 is employed. See Complaint ¶¶ 35-39, 44-48." Id. at 65.

While the correct basis for determining loss or discount in situations of this kind is not entirely clear, and there is authority for each of the two theories postulated by plaintiff, such basis would appear to be the difference between the issue price originally received by the taxpayer (plaintiff) for the preferred and preference stock or the fair value of such stock to the taxpayer at the time of the exchange, whichever is higher, and the face value of the debentures. See Gulf, Mobile & Ohio R.R. v. United States, 339 F. Supp. 489 (S.D. Ala. 1972) (containing a discussion of the pertinent cases in chronological order). While there is authority for the proposition that value at time of exchange is irrelevant when a corporation is retiring its own stock rather than acquiring the stock of some other entity or retaining its own reacquired stock--Erie Lackawanna R.R. v. United States, supra, 422 F.2d 425--later authority is to the contrary. Missouri Pacific R.R. v. United States, supra, 433 F.2d 1324. Indeed, in National Alfalfa Dehydrating & Milling Co. v. Commissioner, 472 F.2d 796 (10th Cir. 1973) the court found, with one dissent, that an allowable discount occurred

when the taxpayer issued $50 debentures in exchange for $50 par value preferred stock when at the time of the exchange the fair market value of the preferred stock was only $33 per share, even though the taxpayer originally had received $50 per share on issuance of the preferred. While this holding runs counter in one respect to what this Court has suggested is the correct basis for determining loss or discount, it is not relevant to the instant case since the value herein in any event cannot be less than what plaintiff originally received.

Returning to the appraisal of William A. Gill dated January 27, 1970, referred to hereinbefore, among the facts and circumstances which he considered were

"a) The economy of the United States during the period 1930 through 1947, inclusive....

"b) The history of the public utility industry with particular emphasis on its experience under the Public Utility Holding Company Act of 1935....

"c) The history of Cities Service Company with particular emphasis on: the history and nature of its business; its experience under the Public Utility Holding Company Act of 1935; its operating results over the period 1935 through 1946, inclusive; its capital structure from inception through May 27, 1947; and the trading activity in its various securities over the 1935-1947 period...." (Def.'s Exh. B, "Rule 9(g) Statement" Exh. 1, Gill Affid. ¶ 15.)

After consideration of these and other factors he concluded:

"(a) In general, the financial condition of Cities Service improved significantly over the period January, 1935 to October 31, 1946. Nonetheless, at all times pertinent to the period of investigation, analysis, and study, the preferred and preference shares of Cities Service, were speculative in nature. While the market prices on the New York Stock Exchange for these preferred and preference shares were supported by active trading during the period January, 1943 through May, 1947.[sic]However, from November 20, 1946 these prices were dependent on the value of the consideration to be received in exchange for such shares; i.e. the 3% Sinking Fund Debentures in the aggregate principal amount of $115,246,950.

"(b) That a valuation of the Cities Service preferred and preference shares as of May 27, 1947 predicated on the plan of simplification as amended fails to reflect the true inherent worth of such shares in light of the fact that from November 20, 1946 to May 27, 1947, the value of these shares was totally dependent upon the value of the announced consideration to be received in exchange therefor; i.e. the new Cities Service Debentures.

"(c) In order to determine the fair market value of the Cities Service preferred and preference shares on their own merits as a security as of May 27, 1947, it is necessary to analyze such shares at that point in time prior to any proposed plan of simplification.

"(d) That in his opinion as of May 27, 1947, the fair market value of the Cities Service preferred and preference shares, on their own merits as a security, without reference to any announced plan of simplification, was as set forth below:

Security	Fair Market Value
$6.00 Preferred	$147.50 per share
$6.00 Preference BB	138.00 per share
$0.60 Preference B	13.75 per share"

(Id. at ¶ 20.)

Plaintiff contended, on the motion for summary judgment, and defendant provisionally conceded for the purpose of that motion, "that at the time of the exchange in 1947 the aggregate fair market value of the preferred and preference shares was $86,313,600.00" based on the Gill appraisal. 316 F. Supp. at 65. Does such "fair market value" constitute the "value to plaintiff" which is the issue before this Court? It seems clear that Gill's appraisal was based on "consideration of all relevant data, including the market value of the shares, the financial condition of the taxpayer at the time of the exchange, its profits prospects and expert opinion." Id. at 73. Furthermore, although, as Judge Mansfield emphasized, market price, while relevant, would not be conclusive (Id.), the average market price for the stocks concerned on November 20, 1946, based on the average of the high and low for the week preceding and following that date, was:

$6.00 Preferred	$149.375
$6.00 Preference BB	$145.375
60¢ Preference B	$14.6875

Obviously, after November 20, 1946, when the original plan was proposed, the market price was dependent on the value of the consideration to be received in exchange for the stock, and nowise constituted a measure of the "value to plaintiff" of the stock, and Gill recognized this in making his appraisal. Furthermore, the average market price for the stock in 1946 was:

$6.00 Preferred	$143.50
$6.00 Preference BB	$136.00
60¢ Preference B	$13.375

Thus it appears that, while the average market price for the period immediately preceding and following the submission of the plan of November 20, 1946, exceeded Gill's determination of a fair market value, the average market price during 1946 was less than that fair market value with respect to each class of stock. Furthermore, the market must have been aware of the situation involving plaintiff well before this time.

The issue resolves itself, accordingly, to the alternative valuations referred to by Judge Mansfield: the fair market value of the stock surrendered upon the 1947 exchange ($86,313,600.00) or the fair market value of the cash and properties originally paid in on the issuance of the stock ($45,323,846.00).[2/] The basic determination is a legal one and, on the basis of the authorities cited herein, requires the rejection of the second alternative.

Accordingly, the Court finds that the value to plaintiff of the preferred and preference shares received by it in exchange for the issue of its 3 percent Thirty Year Sinking Fund Debentures on May 27, 1947, was $86,313,600.00, said valuation being computed as follows:

Class of Stock	No. of Shares	Value Per Share	Total Fair Value
$5.00 Preferred	560,000	$147.50	$82,688,500.00
$6.00 Preference BB	17,700	$138.00	2,442,600.00
60¢ Preference B	86,000	$13.75	1,182,500.00
		Total	$86,313,600.00

Submit final judgment in conformity herewith and with the prior orders entered herein on twenty (20) days notice.

Dated: New York, New York
June 11, 1973

CHARLES H. TENNEY

U.S.D.J.

CITIES SERVICE CO.,
Plaintiff,
-against-
UNITED STATES OF AMERICA,
Defendant.

67 Civ. 4606 (CHT)

FOOTNOTES

1. The preferred stock $6 cumulative was preferred as to dividends over the two classes of preference stocks and the common stock, and the preference BB and preference B stocks ranking pari passu, were preferred as to dividends over the common stock.

   On liquidation or dissolution, whether voluntary or involuntary, the preferred stock was entitled to $100 per share plus unpaid accrued dividends before any distribution was made to other stockholders and the BB and B preference stocks were entitled to $100 per share and $10 per share, respectively, plus unpaid accrued dividends, before any distribution could be made to the common stock.

   The preferred, the BB preference and the B preference stock were subject to redemption, in whole or in part, at any time, by the payment of an amount equal to $112, $106 and $10.60 per share, respectively, plus unpaid accumulated dividends.

2. The $45,323,846.00 figure was subject to defendant's right to contest its accuracy. 316 F. Supp. at 72 n.10. Although defendant elicited from plaintiff's expert Field an admission that he had accepted Judge Mansfield's figures without independent investigation, this would scarcely constitute a satisfactory exercise of its right to contest accuracy. However, in view of the determination reached herein, whether the $45,323,846.00 figure or the stated value of $58,690,000.00 is the correct "floor" is irrelevant.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

A 657

CITIES SERVICE COMPANY,

Plaintiff,

- v -

UNITED STATES OF AMERICA,

Defendant

NOTICE

67 Civ. 4606 (CHT)

SIRS:

PLEASE TAKE NOTICE that on October 17, 1973, pursuant to the opinion of Judge Charles H. Tenney dated June 11, 1973, the attached proposed Judgement with computations will be filed on behalf of plaintiff, Cities Service Company, in the United States District Court for the Southern District of New York. Said proposed Judgement with attached Exhibit "A" (with Schedules I and II) and Exhibit "B", shows the amount due and owing from defendant, United States of America, to plaintiff, Cities Service Company, on account of the overpayment of Federal Income taxes for the years 1953 and 1954, plus costs.

PLEASE ALSO TAKE NOTICE that pursuant to Judge Tenney's opinion dated June 11, 1973, you will have twenty (20) days to respond to this notice.

Dated: New York, New York
October 17, 1973

Respectfully submitted,

THOMAS E. TYRE
345 Park Avenue
New York, New York 10022
Tel: 593-0200
Attorney for Plaintiff

TO:
Paul J. Curran, Esq.
United States Courthouse
Foley Square
New York, New York 10007

EXHIBIT "A"

A 658

CITIES SERVICE COMPANY

Computation of Federal Tax Refund
For Taxable Years 1953 and 1954
Per Opinion of Judge Tenney Dated June 11, 1973

I. 1953

Amortization of Bond Discount (Schedule I)	$649,495.31
Additional Expense a/c Retirements (Schedule II)	260,335.82
Total Deduction	$909,831.13
Tax Rate	.52
Refund 1953	$473,112.19

II. 1954

Amortization of Bond Discount (Schedule I)	$634,169.76
Additional Expense a/c Retirements (Schedule II)	418,724.13
Total Deduction	$1,052,893.89
Tax Rate	.52
Refund 1954	$ 547,504.82

Schedule I

[redacted]59

CITIES SERVICE COMPANY

Amortization of Bond Discount on Account of
3% 30-Year Debentures of 1947.
Per Treasury Regulations Section 1.61-12(c) (3)
(Regs. 118 Section 39.22 a-17(c) for 1953)

Year Ended December 31	Principal Amount Outstanding End of Year	Amortization of Discou on Principal Amount Outstanding (355 Mos.) .0084863741076
	115,246,950.	
1947	112,246.950.	555,665.61
1948	110,746,950.	939,840.05
1949	109,246,950.	927,110.49
1950	81,346,900.	690,340.23
1951	79,846,900.	677,610.66
1952	78,053,400.	662,390.35
1953	76,533,900.	649,495.31 *
1954	74,728,000.	634,169.76 *
1955	73,500,500.	623,752.74
1956	72,033,900.	611,306.62
1957	70,487,400.	598,182.45
1958	69,033,900.	585,847.50
1959	67,533,900.	573,117.94
1960	66,033,900.	560,388.38
1961	64,533,900.	547,658.82
1962	63,033,900.	534,929.26
1963	61,533,900.	522,199.70
1964	60,096,900.	510,004.78

* Taxable years before the Court.

Year Ended December 31	Principal Amount Outstanding End of Year	Amortization of Discount on Principal Amount Outstanding (355 Mos.) .0084863741076
1965	58,463,900.	496,146.53
1966	57,232,100.	485,693.01
1967	55,528,900.	471,239.02
1968	54,037,800.	458,584.99
1969	49,768,400.	422,353.26
1970	48,826,900.	414,363.34
1971	39,349,900.	333,937.97
1972	39,309,700.	333,596.82

A 661

CITIES SERVICE COMPANY

Additional Expense on Account of Retirement of 3% 30-Year Debentures, Per Treasury Regulations Section 1.61-12 (Regs. 118, Section 39.22 (a)-17(c) for 1953)

Year Ended 12/31	Principal Amount of Debentures Retired During Year	Repurchase Price of Retired Debentures	Issue Price of Debentures Retired (.7489447660003)	Amortization of Discount Allowed to to 12/31 of Prior Year on Retired Debentures	Additional Expense Deduction a/c Retirement
(7 Mos.) 1947	3,000,000.	1,589,320.02	2,246,834.30		
1948	1,500,000.	1,272,263.22	1,123,417.15		
1949	1,500,000.	1,998,703.25	1,123,417.15		
1950	27,900.050.	26,997,294.33	20,895,596.42		
1951	1,500,000.	2,676,510.29	1,123,417.15		
1952	1,793,500.	1,968,972.76	1,343,232.44		
1953	1,519,500.	1,398,357.39	1,138.021.57	-0-	260,335.82 *
1954	1,805,900.	1,786,569.02	1,352,519.35	15,325.54	418,724.13 *
1955	1,227,500.	1,197,652.27	919,329.70	20,834.05	257,488.52
1956	1,466,600.	1,351,475.01	1,098,402.39	37,338.35	215,734.27
1957	1,546,500.	1,335,008.01	1,158,243.03	52,496.71	124,268.22
1958	1,453,500.	1,289,038.26	1,088,591.22	61,674.73	138,772.31
1959	1,500,000.	1,221,128.27	1,123,417.15	76,377.37	21,333.75
1960	1,500,000.	1,21[illegible]681.65	1,123,417.15	89,106.93	2,157.57
1961	1,500,000.	1,244,510.65	1,123,417.15	101,836.49	19,257.01
1962	1,500,000.	1,282,190.91	1,123,417.15	114,566.05	44,207.71
1963	1,500,000.	1.297,504.02	1,123,417.15	127,295.61	46,791.26
1964	1,437,000.	1,237,636.65	1,076,233.63	134,144.12	27,258.90

* Taxable years before the Court.

Year Ended 12/31	Principal Amount of Debentures Retired During Year	Repurchase Price of Retired Debentures	Issue Price of Debentures Retired	Amortization of Discount Allowed to to 12/31 of Prior Year on Retired Debentures	Additional Expense Deduction a/c Retirement
1965	1,633,000.	1,223,026.80	1,411,646.59	166,298.99	22,320.80
1966	1,231,800.	922,550.16	1,001,095.02	135,895.70	(57,350.84)
1967	1,703,200.	1,275,602.72	1,375,735.38	202,355.89	(102,223.23)
1968	1,491,000.	1,116,751.54	1,169,032.52	189,810.48	(137,529.50)
1969	4,269,400.	3,197,544.78	3,188,697.51	579,707.61	(588,554.88)
1970	941,500.	705,131.50	686,901.38	135,828.66	(154,058.78)
1971	9,477,000.	7,097,749.55	7,796,611.47	1,447,656.62	(748,794.70)
1972	40,200.	30,107.58	34,027.76	6,481.89	(2,561.71)

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49052

A 663

U.S. DISTRICT COURT
FILED
NOV 20 1973
S. D. OF N. Y.

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

CITIES SERVICE COMPANY,

Plaintiff,

-v-

UNITED STATES OF AMERICA,

Defendant.

JUDGMENT

67 Civ. 4606 (CHT)

Judgt. # 73,917

The Court having entered its opinion in this cause on June 12, 1973, and in accord therewith, the parties having filed computations of the amount of income tax refunds due and owing to plaintiff pursuant to such opinion and prior orders of the Court,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED that plaintiff is entitled to a refund of Federal Income Taxes for the calendar taxable years ending December 31, 1953, and December 31, 1954, in the respective amounts of $636,342.11 and $735,055.80, plus interest as provided by law and allowable costs in the amount of $727.16.

Dated: New York, New York
~~November 7, 1973~~
November 19, 1973

MICROFILM
NOV 21 1973

Charles H. Tenney

CHARLES H. TENNEY
United States District Judge

JUDGMENT ENTERED - 11-20-73

Raymond F. Burghardt
Clerk

CITIES SERVICE COMPANY

Computation of Federal Tax Refund

For Taxable Years 1953 and 1954

Per Opinion of Judge Tenney Entered June 12, 1973

A 664

I. 1953

Amortization of Bond Discount (Schedule I)		$649,495.31
Additional Expense a/c Retirements (Schedule II)	$260,335.82	
Less Computation (a)	71,998.00	
		188,337.82
Total Deduction		$837,833.13
Tax rate		.52
Refund 1953		$453,673.43
plus interest		200,668.68
Total 1953		$636,342.11

II. 1954

Amortization of Bond Discount (Schedule I)		$634,169.76
Additional Expense a/c Retirements (Schedule II)	$418,724.13	
Less Computation (b)	85,569.00	
		333,155.13
Total deduction		$967,324.89
Tax rate		.52
Refund 1954		$503,009.80
plus interest		232,046.00
Total 1954		$735,055.80

ADJUSTED EXHIBIT A

49052

A 2665

COMPUTATION

Face Amount of Debentures	$115,246,950.00
less Issue Price of Debentures	- 86,313,600.00
equals Discount of Debentures	$ 28,933,350.00
divided by Face Amount	÷115,246,950.00
and the Result divided again by the Term of the Debentures, 29 y., 7 mos.	÷355 months/12 months
Equals % of Discount allowable per year per $1.00 Face Amount of Debentures	=0.84863741076%
which multiplied by the Term the Debentures were outstanding with no Amortized Discount claimed by Taxpayer, 5y., 7mos.	X67 months/12 months
equals % of Discount Barred by Statute per $1.00 Face Amount of Debentures Retired in any Particular Year	=4.73757%
a) multiplied by the Face Amount of Debentures Retired in 1953	X$1,519,500.00
equals Amortized Discount Available but not taken by Taxpayer on Debentures Retired in 1953	=$71,998.00[a]
b) multiplied by the Face Amount of Debentures Retired in 1954	X$1,805,900.00
equals Amortized Discount Available but not taken by Taxpayer on Debentures Retired in 1954.	=$85,569.00[b]

Taxpayer's Exhibit A is attached as adjusted by computations (a) and (b) above.

On March 23, 1962, taxpayer paid a tax deficiency for 1953 plus interest. The allocable part of that interest ($200,668.68) has been added to the judgment. Interest on the total 1953 refund ($636,342.11) runs from March 23, 1962, at the statutory rate.

On December 3, 1962, taxpayer paid a tax deficiency for 1954 plus interest. The allocable part of that interest ($232,046.00) has been added to the judgment. Interest on the total 1954 refund ($735,055.80) runs from December 3, 1962, at the statutory rate.

7/17/74

4 Copies Recd

Thad Holt

for Cosey Craig Courtroom